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OVERSIGHT ON IMPACT OF TAX PROPOSAL ON PRIVATE SECTOR EMPLOYEES' BENEFITS

HEARING

BEFORE THE

SUBCOMMITTEE ON LABOR

OF THE

COMMITTEE ON
LABOR AND HUMAN RESOURCES
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

EXAMINING PROPOSED CHANGES OF PENSION POLICY IMPLICATIONS OF THE PRESIDENT'S TAX PROPOSALS OF FRINGE BENEFITS AND RETIREMENT SAVINGS

OCTOBER 1, 1985

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OVERSIGHT ON IMPACT OF TAX PROPOSAL ON PRIVATE SECTOR EMPLOYEES' BENEFITS

TUESDAY, OCTOBER 1, 1985

U.S. Senate,
Subcommittee on Labor of the
Committee on Labor and Human Resources,
Washington, DC.

The committee met, pursuant to notice, at 9:50 a.m., in room 430 of the Dirksen Senate Office Building, Senator Don Nickles (chairman of the subcommittee) presiding.

Present: Senators Nickles and Simon.

Senator Nickles. Good morning. I apologize to all of our guests and witnesses for being 20 minutes late.

I was at the White House for breakfast and ended up leaving a little early as it was. Sitting at the President's table makes it difficult to say, "Excuse me, I have to leave to conduct a hearing."

I do apologize. I think, in 5 years, this is the first time we have been 15 or 20 minutes late in starting any hearing and I hope that it doesn't happen again.

I have a statement which I'll enter into the record.

OPENING STATEMENT OF SENATOR NICKLES

Good morning. Today's hearing focuses on the impact of the President's tax proposal on private sector employee benefit plans. Changing the law for employee benefit plans from only a tax or revenue raising perspective without any reference to the impact on policy is, in my opinion, a mistake of enormous proportions. This type of approach could admittedly very well result in some immediate added revenue to the General Treasury. Long term, however, the results could be tragic.

For example, one of the most controversial aspects of the proposal is the elimination of 401(k) plans. Treasury estimates a revenue gain of $11.6 billion from 1986 to 1990 if these plans are eliminated. However, for many persons unable to plan for retirement with an IRA, a 401(k) plan is their best possible if not only alternative to provide some retirement savings. As testimony will confirm today, these 401(k)'s are not utilized primarily as a tax shelter for the rich. I am strongly opposed to eliminating 401(k)'s.

The next major area where I would take issue is the proposal on qualified plan distributions from tax-favored retirement plans. Under the proposal, a series of strong tax disincentives designed to force an individual to avoid a lump-sum distribution are provided to encourage a retirement income stream. By way of example, 10-

year forward averaging would be eliminated along with special capital gains treatment.

Currently, if contributions are made with after tax dollars, at retirement, this money comes out first without any additional tax liability. Under the proposal, all of the taxable dollars would come out first. This aspect is one not only confusing but also ridiculous. How one knows when to switch from taxable to nontaxable at the end of the recipient's life is somewhat of an actuarial mystery to me.

Some of the other new distribution requirements also give me pause. The 20-percent excise tax on distributions prior to age 59½ without regard to major medical or other hardships appears harsh. An additional 10-percent excise tax added on top of the other tax if a sizable distribution over $112,500 is taken out in a lump sum after retirement seems too punitive. If an individual takes his or her money out in a lump sum before age 59½ and the distribution is sizable, the tax cost can be a 30-percent excise tax with no income averaging which can cost another 10 percent. If the individual is over age 59½, the income averaging is still gone plus the 10-percent excise tax for large distributions.

The inclusion of the new nondiscrimination rules in a proposal designed to make the system simple and fair is contradictory. The new prohibited group and 125-percent tests are anything but simple. Further it does not seem fair that an employer can cover all employees and the plan still be held to be discriminatory. These new rules did not appear in the November 1984 proposal but later appeared in May 1985. Further, this policy proposal is revenue neutral and has no place in a tax proposal.

There are other rules impacting only on welfare plans, unemployment and disability payments, and an excise tax on reversions at termination. I think I have made my point, however, I have some serious reservations about the proposal.

Let it suffice to say that I am concerned about several of the proposals in the so-called Treasury II, as amended, package that is now before Congress as it deals with pensions. Some particular concerns are in the pension community with some of the changes which would involve plant administration and pension plan policy, termination of 401(k)'s, the way in which lump sums would almost be prohibited by eliminating 10-year forward averaging, and by tax implications saying that you wouldn't receive your dollars back first which you have already paid taxes on.

The distribution requirements could be very hazardous to the health of defined-benefit plans and to the pension industry, as well. I think it's important that Congress consider the ramifications of the proposals on pension policy and not just look at pension areas as another means of raising revenue.

It's important that we work to secure the solvencies of private pension systems, and not do anything which would jeopardize those and encourage and increase the dependency on public systems.

Our first witness is Frank Swain, Chief Counsel for Advocacy of the U.S. Small Business Administration. As a member of the Small Business Committee, I appreciate the work you have done in assisting us as well. Thank you very much.

We have a number of witnesses and would appreciate it if you would summarize your remarks. Thank you very much.

STATEMENT OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. Thank you very much, Mr. Chairman. I appreciate your interest in these issues both as a member of the Labor Committee and as a member of the Small Business Committee.

As you know, the SBA Office of Advocacy was established by Congress to represent the views and interests of small business within the Federal Government. Therefore, my perspective is that of the small business owner.

We are not here representing the official view of the administration on the tax bill. That, of course, is represented very ably by the Treasury Department.

My role this morning is to provide the committee with information on the small business impact of the proposed changes. I think it is certainly important that this committee is focusing on these issues because, as you mentioned in your opening statement, not only are the tax and revenue consequences significant, but the consequences to pension policy are important as well.

I think it is important to point out that from the perspective of pension and health care policy, we have a real problem with small business. The basic problem is that, of all of the groups of employers and employees in the United States that are not covered by any sort of pension or health care plan, it is usually small business that doesn't have very much coverage, especially in the pension area but in the health area as well.

I cite in my statement some of the current statistics on pension and health coverage by size of firm. For example, in 1983 only 19 percent of the workers in firms employing 25 or fewer employees were offered pension coverage—19 percent—as opposed to 86 percent in firms with over 500 workers.

For health insurance, the same trend exists. In 1983, only 39 percent of the workers in firms with fewer than 25 employees were covered by employer health plans as compared to 85 percent in firms with over 500 employees.

Therefore, if a policy goal of the Federal Government is to increase pension and health coverage, then the most "bang for the buck," if you will, will be from increasing pension and health care coverage by small employers of their workers. I think that, naturally, the next logical question would be to ask why that coverage is lacking now.

First and foremost, the lack of stable and significant cash-flow and profits in small firms is an inherent barrier to setting up pension, profit sharing, and health care plans; and certainly the stable and growing economy is the best tonic to that particular problem.

But close on the heels of the problem that many small business can't afford the direct funding cost of pension plans and health care plans is the fact that many small firms cannot afford the indirect costs: that is, the ongoing administrative costs, the startup costs in setting up the plans: the out-of-house expenditures for lawyers, accountants, insurance carriers, and so on.

In fact, some studies that we have done indicate that it costs a smaller firm approximately twice as much per employee as it does for a large firm with over 500 workers to set up and maintain the administrative expenses of a defined benefit plan. Defined benefit plans, of course, have some very good tax consequences however, they are becoming too expensive for most small firms to set up.

Therefore, we start from the perspective that every time the laws are changed regarding pension and health care plans, that the changes in and of themselves—regardless of whether they are good, bad or indifferent—present a further deterrent to establishing plans.

Employers tell us that they are suffering from a sort of triple blow in the last 4 years. We've had DEFRA and TEFRA and, this past year, the Retirement Equity Act. Each law has forced almost anyone who has a pension or a profit-sharing plan to go back to their accountant, to their attorney to have it redone.

I run into a lot of small employers that say, regardless of whether the new requirements are good, bad, or indifferent, that they cannot stand the constant-changing law and they are going to drop their coverage and certainly not expand it.

Our initial point is that Congress should carefully balance the goals of any new legislation against the likely impact of new rules on the delivery of employee benefits in small firms. Unless there are significant revenue issues or significant social policy goals to be achieved, Congress should be careful to ensure that any new rules minimize what is, almost by definition, a heavier impact on the employee benefit plans of small business.

In that context, I would like to point out that we feel that the most important vehicle for retirement savings in small business is the defined-contribution plan. Approximately 70 percent of the workers in small firms that are covered, are covered by only defined-contribution plans.

Defined-contribution plans are typically not the only retirement plan in larger firms—about 7 percent of covered workers in larger firms are covered by only defined contribution plans as compared to about 70 percent in smaller firms. It's easy to understand why: defined contribution plans are relatively simple and inexpensive to set up and maintain.

Therefore, we urge that the Congress be particularly cautious in enacting any new sets of rules and regulations that would significantly deter the establishment and make more expensive the establishment of defined-contribution plans for small employers.

On the question of the administration tax proposal, I think I should state clearly that I think that, on balance, the administration tax proposal is a very good proposal for small business for three particular reasons.

No. 1, it decreases the individual tax rates. Most small businesses are in business as sole proprietorships or partnerships. No. 2, it retains and, to some degree, broadens reduced corporate tax rates and maintains graduated rates. In our polls, in our work around the country with small business, that seems to the No. 1 tax issue for small corporations: to keep those basic rates down.

No. 3, the tax plan indexes the capital cost recovery system against inflation, which I think provides significant assistance to small business and tends to even out the score from some of the restrictions that have been imposed.

Therefore, in general, we think that the tax reform proposal has some very good things in it for small firms. We are not quite as optimistic, however, in the pension and profit sharing area. Our testimony points out a couple of the specifics which we feel could be remedied by the committees involved.

We certainly hope that this committee would report to the Finance Committee on your feelings after these hearings this morning and any other hearings that you may have.

The tax reform proposal of the administration would contain both a uniform nondiscrimination rule and a uniform concentration test for both employee pension and welfare benefits. In considering these proposals, the Congress should be careful to assess the likely effects of particular aspects of these proposals on the welfare benefit programs of small employers.

I would briefly point out, Mr. Chairman, a couple of the things that we know. On the issue of a nondiscrimination test for health insurance plans, among other things, the administration proposal would exclude from the test certain classes of employees, including part-time and seasonal workers, and full-time employees with less than 30 days' service. These employers may be excluded in applying the proposed test to determine if covering under the plan is discriminatory; that is, disproportionately favoring owners and highly paid employees.

There is a lot of turnover in small business. A lot of people come to work, say they are going to work full-time, and, as you know, end up leaving the job shortly after they are hired.

We think that 30-day rule is unreasonable. If there is going to be a nondiscrimination rule, it should be applied to a workforce that has demonstrated a certain longevity and loyalty to the employer.

We would suggest, as a minimum, a 90-day rule for a class of excludable employees to reflect the relatively higher turnover of labor that small firms experience.

On the issue of the concentration test, I think the Congress has to be very careful in establishing any concentration test for health insurance benefits because the arithmetic is such that small firms with three or four or five employees can very unintentionally fail the concentration test if it is not written carefully. This area is very touchy for most small businesses, to say nothing of the inherent complexity of applying the proposed test. We have some specific proposals in our written statement that involve more liberal definitions of the prohibited group members for purposes of applying the concentration test.

There is another troubling issue for small business. If the Congress is going to go ahead and enact any new rules for pension and health plans, it exists in the current system. That inequity is the ability of owner/employees of corporations to exclude health insurance premiums from income and the inability of sole proprietors, partners and certain owners of sub "s" corporations to receive the same tax-favored treatment.

We are recommending that the tax exclusion for health care benefits be extended from just the corporate form to all forms of business.

If it makes sense to make available a certain tax-favored benefit, then that benefit ought to be available to all forms of business.

Finally, we endorse the committee's long-range human welfare goals to expand pension and health coverage to the vast majority of American workers. I think the high levels of coverage already achieved among larger firms demonstrate that the current tax system is working, however, it is not working quite well enough for small firms. We hope that as the committee is studying this issue and recommending that any new proposals be very sensitive not to go too far to restrict the already low levels of benefit coverage in small firms. If anything, we hope that the committee will try to look for ways to expand coverage in small business consonant with the revenue and simplicity goals that I think we all endorse.

I'd be happy to take any questions, Mr. Chairman, now or later.

[The prepared statement of Mr. Swain follows:]

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

STATEMENT OF
FRANK S. SWAIN
CHIEF COUNSEL FOR ADVOCACY
U. S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
SUBCOMMITTEE ON LABOR
COMMITTEE ON LABOR AND HUMAN RESOURCES
U. S. SENATE
TUESDAY, OCTOBER 1, 1985

Mr. Chairman:

Thank you for the opportunity to present my views on the tax treatment of employee benefits. The Office of Advocacy of the U. S. Small Business Administration was created by Congress in 1976 to advocate the interests of small business before the Congress and Federal agencies. Thus, my views are not necessarily those of the Administration; the Department of Treasury represents the Administration on tax issues. My role is to provide the Committee with information on the small business impact of the proposed changes. I applaud the subcommittee for its consideration of the impact of tax reform on long-range employee benefits goals. Because small businesses (with less than 500 employees) employ approximately 57 percent of the private sector workforce, it is necessary to carefully examine the impact of our tax and labor laws on the small business sector. The cost, complexity and administration of benefit programs are significant payroll burdens for small employers and can affect the ability of small business to continue its impressive record of job creation and innovation.

I. General Remarks

First, I would like to stress the critical importance of employee benefits to the small employer. Small businesses are striving to compete with large businesses for qualified employees. The whole package of compensation that an employer can offer an employee, which includes basic pension and health benefits in addition to a decent wage, is what attracts workers to accept particular jobs. Research conducted for the Office of Advocacy indicates that the primary reason small employers provide health and pension benefits is to attract and retain productive employees. Small employers report that health insurance benefits have become almost a required "perk." To enable small employers to effectively compete for good workers, it is necessary to ensure that small business is put on equal footing with large business, to the greatest extent possible, in its ability to provide basic employee benefits.

Despite the importance of health and pension benefits to the small employer, small business lags far behind large business in providing basic employee benefits. Research indicates that the likelihood of pension coverage increases dramatically with a business' size. (See Table 1). For example in 1983, only 19 percent of workers in firms employing 1-24 workers were offered pension coverage, as compared to 86 percent in firms with over 500 workers.

For health insurance, the same trend exists, although small businesses are more likely to offer health insurance than pension benefits. (See Table 2). In 1983, 39 percent of workers in firms with 1-24 employees were covered by their employers' health insurance plans, as compared to 85 percent in firms with over 500 workers. Given the significant level of pension and health care coverage already achieved in large firms, any significant expansion of worker coverage will occur in small businesses, particularly those firms with fewer than 100 employees.

To expand employee benefits in small firms, it is necessary to understand why many small businesses do not provide any employee benefits. Research indicates that the primary reason for low pension coverage in small firms is the lack of stable profits to direct to pension plans. The second, and perhaps more relevant reason when tax reform is being contemplated, is the high administrative cost of maintaining benefit plans. The administrative costs of benefit plans tend to be relatively fixed; consequently, small businesses end up paying more than large businesses in administrative costs per employee. In the area of defined benefit pension plans, research indicates that it costs the smaller firms (with fewer than 10 employees) approximately twice as much per employee than it does for large businesses with over 500 workers.

Government regulation directly affects the administrative costs of benefit plans. Each time the tax and labor laws are changed, small businesses must spend disproportionately more to bring plans into compliance. This results from the economies of scale that can be achieved in large plans as well as the lack of in-house resources in small business to service employee benefit plans; the small business "bookkeeper" is simply not equipped to bring a pension plan into compliance with the most recently enacted tax law. Small employers must rely on out-of-house attorneys, actuaries, and consultants to service and amend plans when the law is changed. Small employers are still attempting to adapt to the last round of new laws affecting retirement plans, most notably the Tax Equity and Fiscal Responsibility Act (TEFRA), the Deficit Reduction Act (DEFRA), and the Retirement Equity Act (REA).

In considering whether to adopt new rules for employer-maintained benefit plans, Congress should be sensitive to the fact that the burdens of additional changes, particularly on retirement plans, may be relatively greater on small businesses than on large businesses. Congress should carefully balance the goals of new legislation against the likely impact of new rules on the delivery of employee benefits in small firms. If new rules are necessary to achieve significant revenue or social policy goals. Congress should ensure that the rules are designed to minimize the disproportionately adverse impact on small firms.

In considering legislation affecting employer-maintained retirement plans, Congress also must recognize the importance of defined contribution plans to small businesses. Approximately 70 percent of workers covered by retirement plans in firms with less than 100 employees are covered by only a defined contribution plan; this is compared to 7 percent of covered workers in firms with 100 or more employees. The reason for the prevalence of defined contribution plans in small business is because defined contribution plans tend to be simpler and cheaper to administer than defined benefit plans. Indeed, for the overwhelming majority of small employers, defined contribution plans offer the only viable retirement plan option.

Recently, however, defined contribution plans have come under attack because many of the plans allow employees access to the funds prior to retirement. Some pension industry observers believe that restrictions on early withdrawals and annuitized payments during retirement would better ensure adequate retirement income security.

In efforts to discourage the use of tax-deferred savings for nonretirement purposes, however, it is important not to alter the basic design of defined contribution plans nor create disincentives to their establishment. Policymakers must carefully tailor limitations to employees' pre-retirement use of the funds, without inadvertently raising barriers to defined contribution plan formation.

II. The Administration Tax Proposal

Overall, we believe the Administration tax proposal will be beneficial to most small businesses. Tax reform can simplify business decisionmaking and ease the creation and expansion of small firms throughout the economy. The proposed reduction of individual income tax rates would benefit many of the sole proprietorships, partnerships and subchapter "S" corporations. Approximately 80 to 85 percent of small employers do business in these enterprise forms. The reduction of corporate rates and retention of a graduated corporate rate structure would also help many of the incorporated small firms. In addition, the move to a capital cost recovery system that takes inflation into account will aid many of the small capital-intensive companies. For these reasons, I strongly support the Administration's tax reform proposal.

The Administration's tax reform proposal contains both a uniform nondiscrimination rule and a uniform concentration test for employee pension and welfare benefits. In considering these proposals, Congress should be careful to assess the likely effects of particular aspects of these proposals on the welfare benefit programs of small employers.

The proposed uniform nondiscrimination rule would apply to a variety of employer-maintained benefit plans, many of which are treated differently under the current law.[1] The proposed nondiscrimination rule is intended to bring consistency to current law and to ensure that pension and welfare benefits are actually provided to a broad cross-section of an employer's employees on a nondiscriminatory basis.

I would like to discuss the proposed nondiscrimination rule as it would apply to health insurance plans, which are not subject to nondiscrimination standards under current law. Under the proposed rule, certain classes of employees may be disregarded in determining whether an employer's health insurance plan satisfies the nondiscrimination test. Among the proposed classes of excludable employees are (i) full-time employees with less than 30 days service[2] and (ii) part-time and seasonal employees.

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[1] Under current law, employer-maintained group legal service plans, cafeteria plans, educational assistance programs, dependent care programs, self-insured accident and health plans, and group life insurance are subject to different nondiscrimination standards. In addition, profit-sharing, pension, stock bonus and annuity plans are subject to a different set of nondiscrimination tests. Employer-provided health insurance benefits are not subject to a nondiscrimination rule under current law.

In assessing whether it is appropriate to require consideration under the nondiscrimination test of full-time employees with only 30 days of service, Congress should be aware that small businesses generally experience a relatively high turnover of employees. Research indicates that the smaller the business, the more likely that employees hired full-time will work only 1 to 26 weeks per year. As a result, the 30-day rule may work an unfair hardship on small firms. With workers frequently moving in and out of the workforce, small employers will have to frequently assess their plans for discrimination and suffer high administrative and premium costs because of their greater likelihood to employ workers for very short terms.

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[2] If the plan provides post-separation coverage of at least 90 days, however, employers may exclude full-time employees with 90 days of service.

In addition to the uniform nondiscrimination rule, the Administration's tax proposal would apply a uniform concentration test to employer-maintained welfare benefit plans, including health plans. A similar concentration test is applied under current law to group legal service plans, cafeteria plans, educational assistance programs, and dependent care assistance programs. The test is intended to ensure that the favorable tax treatment granted for welfare benefits achieves the delivery of such benefits to individuals who would not otherwise purchase the benefits on their own. If a substantial portion of the benefits provided under a plan is not for such individuals, but rather is for highly compensated employees, the plan is not satisfying the social objective that justifies the favorable treatment.

Under the proposed test, no more than 25 percent of the total premium contribution to a health insurance plan can be for the benefit of the employer's twenty top prohibited group members by compensation.[3] If an employer's plan fails this test, the excess of the employer's premiums over 25 percent would be taxable to the top twenty prohibited group members.

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[3] The proposal defines "prohibited group members" as (1) a one percent owner; (2) an employee earning over $50,000; (3) an employee earning over $20,000 who is in the top 10 percent of employees by compensation or who is one of the top three employees by pay; and (4) a family member of another prohibited group member.

Under the proposed concentration test, a sole owner-employee of a corporation would be able to exclude from income only 25 percent of his health insurance premium, as opposed to 100 percent under current law. The percentage of the sole owner-employee's excludable premium would increase as he provided health benefits to additional numbers of rank-and-file employees; 100 percent of his own premium would be excludable when the corporation's plan provided health benefits to three or more rank-and-file employees.

In assessing the proposed concentration test, it is important for Congress to consider the effects of such a test on small businesses. We recognize that it may be appropriate to phase-in the favorable tax treatment of benefits as additional rank-and-file employees are covered under a plan. However, we are concerned that the proposed concentration test may be overbroad because it phases in the favorable treatment too slowly. If a concentration test is to be applied to tax-favored benefits, particularly health insurance, Congress should consider ways to target those specific situations for which favorable tax treatment should be restricted. To achieve this result, Congress should consider adopting a more narrow definition of "prohibited group" members for purposes of the concentration test than that contained in the tax reform proposal.

Finally, we believe that, in the context of tax reform, Congress should attempt to remedy a very serious inequity regarding the availability of the favorable tax treatment for health and life insurance. Under current law, the favorable treatment for these benefits is available only to common law "employees," and not to sole proprietors, partnerships or two or more owners of sub "s" corporations. As I mentioned before, an estimated 80 to 85 percent of all small businesses conduct business in these enterprise forms. This restriction discourages the delivery of important welfare benefits to these small business owners as well as to their employees. For example, in 1983 only 28 percent of sole proprietors purchased their own health insurance coverage as compared to 65 percent of the incorporated self-employed.

There is no justification for conditioning the availability of favorable treatment for the owners of businesses on the form of the business operation. The form of business operation has nothing to do with whether the social purpose underlying the favorable treatment of a benefit would be adequately fulfilled by making the treatment available to that business.

We recognize, however, that extending the favorable treatment of group-term life insurance and health benefits to all business owners, regardless of form, may result in a significant revenue loss. Thus, it may be very difficult to adopt such a proposal in the context of fundamental tax reform that aims to achieve revenue neutrality. However, we believe that, in reviewing the employee benefit provisions of the tax law, Congress should make every attempt to eliminate this unjustifiable inequity. We would like to point out in this regard that prudent policy may support pairing a more liberal concentration test with an extension of the favorable treatment for group-life insurance and health benefits to the owners of all businesses, regardless of the form of operation. Under such a concentration test, the owners of small businesses would be eligible for favorable treatment of these benefits and the level of such favorable treatment would rise as an increasing percentage of benefits are provided to rank-and-file employees.

Conclusion

One of the Federal Government's long range human welfare goals is to expand pension and health insurance coverage to the vast majority of American workers. The high levels of coverage already achieved among large business employees demonstrate that the current tax system is working.

To significantly expand worker coverage, however, the system must work, and work well, in the small business sector. Some small businesses will simply never be able to afford the costs of employee benefit plans. However, for those that can now afford these costs, and those that someday may be able to afford benefit plans, the system must be simple, flexible and relatively low-cost. There should be no significant revision of the employee benefits tax structure unless any of these goals is certain to be achieved.

Table 1

Percent of Wage-and-Salary Workers in Firms Offering Pension Plan Coverage by Employment Size of Firm, 1979 and 1983

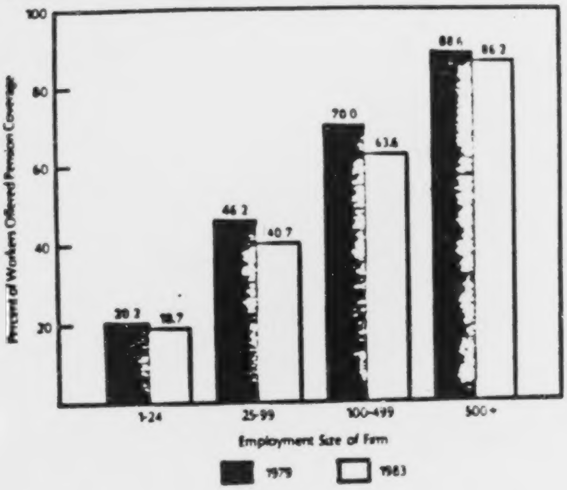
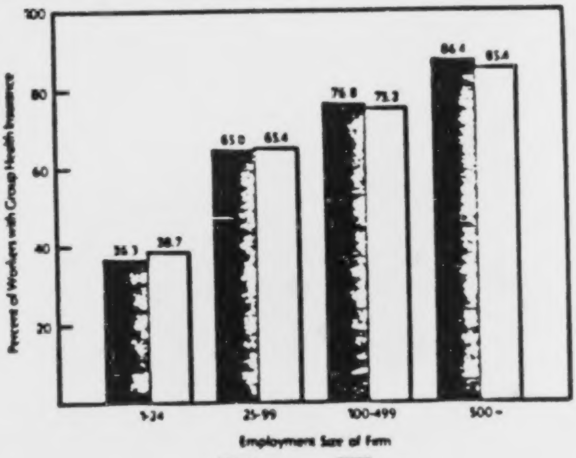


Table 2

Percent of Wage-and-Salary Workers in Employer's Health Plan by Employment Size of Firm, 1979 and 1983



Source: U.S. Department of Commerce, Bureau of the Census, Current Population Survey, May 1979 and May 1983, unpublished data

Senator NICKLES. Thank you, Mr. Swain. We appreciate your appearance.

Senator Simon, we appreciate your joining us as well. Do you have any opening comments?

Senator SIMON. I do not; and, unfortunately, I have three committee meetings going on at the same time, as we often do.

I do note that one of the witnesses, who will testify a little later on, is from the Peoria Journal-Star. I hope Mr. Noch's testimony will be listened to with great intensity.

I do not have any opening statement.

Senator NICKLES. Thank you very much Senator Simon.

Mr. Swain, the concept of tax simplification is appealing to all, but when you get into some of the proposals as they pertain to pensions discrimination, concentration rules and so on, they aren't simple.

Mr. SWAIN. Yes, sir.

Senator NICKLES. I would share your statement that if we are not careful and we continue to make, particularly, defined-benefit plans and possibly defined-contribution plans more complicated, you are going to have more of a problem for small business participation.

I also think your comment is exactly correct. When I have visited with many small businesspersons, they say they are very concerned about having to have their plan amended every year it would be in compliance and still qualify as a plan.

We've done it three times in the last 4 years.

Mr. SWAIN. That's right.

Senator NICKLES. No doubt, if we are looking at a tax bill, there will be changes as well.

Part of the last proposal was elimination of section 401(k)'s. I didn't hear your statement mention that.

Do you think that would have an adverse impact on small business?

Mr. SWAIN. Well, to be very candid, Senator, we're not really sure. It certainly would have an adverse impact on small businesses that have section 401(k) plans. There are no two ways about that.

The statistics that we have indicate that section 401(k) plans are not used nearly as much in small firms as they are in large firms. That is certainly understandable because the very nature of a section 401(k) plan, with a variety of benefits and recordkeeping over time, requires you have to have a certain sized firm that has an outside consultant and or computerized payroll system to set up and maintain the plan. Therefore, for the vast majority of small firms that don't have section 401(k) plans, or any type of pension plan, the proposed elimination of 401(k) is probably not a real issue.

We do, however, see some trend toward growth in the use of section 401(k) plans among small firms. The statistics really aren't up to date. So I think that it's a certainly a potential problem. On a continuum of things, however, it's not the worst thing in the bill; but it's certainly not the best thing, especially for those firms that use section 401(k) plans.

Senator NICKLES. Is your biggest concern with what's proposed in the bill be nondiscrimination and concentration rules as they would apply to health insurance plans?

Mr. SWAIN. Yes. I think that's fair to say: the potential complexity of those rules in an area that has clearly not been regulated before.

There may be health policy reasons to impose new tests, but it's so easy to go too far when you begin to open that door at all.

Senator NICKLES. Are you concerned primarily with health and accident plans, or also with pension plans?

Mr. SWAIN. Well, on the pension plan side, the concern that we hear most often is adding to the cost of setting up the plan in the first place. Of course, many of the proposals included in the administration's bill don't relate so much to that side of it, but to various restrictions on distributions; in other words, the tax consequences to the employee at a later point.

It's a little bit more difficult for us to judge of the effects of these proposals on small employers.

I would say, on the health care side some of the proposals would clearly increase the up-front administrative costs of setting up the plan in the first place. So the proposals to regulate health plans present more of an immediate problem than what may happen 3 or 4 years down the road when an employee decides to take out a lump sum distribution from a pension plan.

I would like to mention, however, that by their very nature, small firms have difficulty being perpetual recordkeepers for employees who prefer annuity payments over lump sums. We certainly endorse the threshold in the current law, the $3,500 threshold, that permits employers to require workers to take a lump sum. I think that this provides small employers with flexibility.

Senator NICKLES. As a small businessperson, before my election to the Senate and also as administrator of a pension plan, I can tell you the most popular option by far in our defined-benefit plan was lump-sum option.

Under the proposal, lump sums would really be almost prohibited in the fact that there would be excise taxes and you would lose 10-year forward averaging. It would make it very, very difficult for individuals who have that option now.

Basically, they would lose that option or financially it would be so punitive that it would no longer be the wise option to take.

I personally think that is not good pension policy. A lump-sum option, in many cases, is a preferable option for those individuals. It may have been by contract or agreement with their employee, contributing, saving for, in many cases, a lump sum. I am very troubled that Congress or the administration would come in and prohibit that by excessive taxation. They may have been building and accumulating to buy a home or take a trip. Maybe their health was in such a situation they weren't looking for a lifetime annuity.

Many small businesses may be working to accumulate for a lump-sum target. They have told the individuals, "That is what you will receive. Now, if you want to buy an annuity with that, that is your option."

For us to go in and tell that small businessperson they can't do that, I think, is a serious error in pension policy. I don't know where Congress, the administration, or whoever, gets the right to come in and mandate that all pensions should be joint survivor annuities.

That is really the thrust of the proposal, particularly as it pertains to small business. I see a lot of falacy in that concept, and it is one that I think should be changed.

Do you agree with that?

Mr. SWAIN. Well, I think it's pretty much a straight policy call by the Congress. As I understand it, there are not a lot of revenue implications on these particular rules one way or the other.

I think the Congress has every right to define a series of circumstances in which the money is earned in 1 year and the taxation is deferred because it is put aside for retirement purposes. The extent to which you want to scale back and say, "Well, you really don't need to keep it to retirement. You can take it out in a lump sum," for some valid reason—whether it's education of children, purchase of a house or whatever—that's really a policy call that the Congress has every right to make, of course.

But there is no question that the complexity of that system retards the likelihood of having a plan set up by the employer or having the employees be interested in the plan, rather than prefer to take the money now in cash and have no retirement income security.

Senator NICKLES. Thank you.

Senator Simon, do you have any questions?

Senator SIMON. Just one question, Mr. Chairman.

Mr. Swain, in response to one of the chairman's questions, you said we are not really sure. Isn't one of the things that bothers small businesses—and I used to be in business, myself, and certainly would have been categorized as a small businessperson—the uncertainty of where we are going on tax laws, pension laws, environmental laws, and everything else?

To the extent that we can sensibly have some stability, we encourage the business sector, small and large, in this country.

Mr. SWAIN. Absolutely, Senator. I could not have said it any better.

The thing that we hear about that is most troubling to small business owners is their constant going back to check with their various consultants and lawyers and professional advisors.

They are willing to put money into the system for their employees; they are willing to live by a rational set of rules that serve whatever important goals. But the fact that they have to change them from year to year to year because of various priorities that change in Washington, or from people rethinking rules, is very troublesome.

I know it sounds simplistic, but while ERISA solved a lot of problems, it caused many as well. You can't get around the fact that ever since ERISA there has been a general slowing down in small employers offering pension coverage to their employees, especially defined benefit plan coverage. There are just no two ways about it.

I don't think that the slowdown is happening because small business people are selfish and want to keep all the money for themselves. Usually, the small businesses are the job-generators: they know their people better, they want to keep them, they don't want to see them go to some larger firm that offers a big variety of benefits. They genuinely want to provide for their employees. It's just getting very expensive from an administrative standpoint to do so, quite apart from whether they have the cash-flow to put the contributions in in the first place.

Senator SIMON. Thank you, Mr. Swain.

Thank you, Mr. Chairman.

Senator NICKLES. Thank you, Senator Simon.

Mr. Swain, thank you very much for your appearance before the committee.

Mr. SWAIN. Thank you, Mr. Chairman.

Senator NICKLES. On our next panel, are Vance Anderson, Employee Relations Counsel from Mobil Oil, representing the ERISA Industry Committee, and also Deane McCormick, President of the Association of Private Pension and Welfare Plans.

Senator NICKLES. Mr. Anderson.

Mr. ANDERSON. Mr. Chairman, thank you for having us here this morning. I am accompanied by Mark Ugoretz who is Executive Director of ERIC.

I would like to have my full statement inserted in the record if it's acceptable to you.

Senator NICKLES. Certainly.

Mr. ANDERSON. I will summarize my remarks.

Senator NICKLES. Thank you.

STATEMENTS OF VANCE J. ANDERSON, EMPLOYEE RELATIONS COUNSEL, MOBIL OIL CORP., REPRESENTING THE ERISA INDUSTRY COMMITTEE, ACCOMPANIED BY MARK J. UGORETZ, EXECUTIVE DIRECTOR; AND DEANE E. McCORMICK, JR., PRESIDENT, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, ACCOMPANIED BY STUART J. BRAHS, EXECUTIVE DIRECTOR

Mr. ANDERSON. I'm Vance Anderson, employee relations counsel for Mobil Oil Corp. I'm appearing here today as chairman of the Retirement Security Committee of ERIC, the ERISA Industry Committee.

ERIC is an industry association that represents over 100 of the Nation's major employers, all of whom sponsor a wide array of benefit plans. The beneficiaries of these plans number in excess of 9 million workers and retirees.

Because of that, we share with this committee its interest in the vital national policies affecting the treatment of pensions, savings plans, and other benefit plans.

Inasmuch as national policy recently seems to have been framed more or less in the context of tax policy, my comments today are directed to the policy initiatives which appear to underlay the administration's tax proposals of recent months.

Our concern in this regard, Mr. Chairman, is that we perceive that whatever one may think about the initiative for tax reform itself—and let me suggest that our members, quite frankly, fall on both sides of that issue: we have a number of our members who feel very strongly that tax reform is an important necessary step to be taken by Congress, we have others who are not so convinced—I would say that it is clear to me that there is broad unanimous opinion within the membership that the proposals in the tax bill as they reflect national policy or proposals for national policy in the benefits area are ill-founded and inappropriate.

The limits, restrictions, cutbacks and curtailments which appear to be a keynote of the initiatives from the administration are a threat, a dire threat to the private system of retirement and welfare benefit plans.

In specific, we have concluded that these proposals, if enacted, would have the effect of reducing benefit levels for workers currently covered, the vast majority of which we would like to point out are less than $25,000 a year. So in no way could we say that they are among those who are sometimes referred to as fat-cats or highly compensated people.

Second, it will reduce the funding for qualified plans, which will have the result of reducing the plans' security, which is now available to our participants and retirees. It will also have the effect of diminishing the pool of capital available to drive the engine of industry in this country and job creation.

Third, it will reduce the retirement income security for millions of workers who will either lose their current coverage or opt not to participate in a system which ties up their savings in a financial straitjacket.

In addition to that, we believe that there is greater economic cost for the remaining participants if these proposals go into effect. There is also a threat of a prospect of greater cost to the Government if in Congress, here, experience an increased demand for public provision of these benefits as the private sector retreats or withdraws from providing them.

These consequences appear to us to have been overlooked in the context of the tax debate where all too often the consideration of these matters seems to be subsumed into a balancing of revenue gain and revenue loss.

Given the widespread coverage and participation of the private system, it would seem to us that the proper addressing of these issues would be cast more in terms of the public policy on pension and benefit plans, generally. Yet we do not see that discussion taking place at this stage.

Accordingly, we are very pleased that you have had this hearing today, Mr. Chairman.

It's our conviction that the efficiency, flexibility and perhaps even the existence of the present system as we know it now may be directly threatened by these proposals. In particularly, we would like to draw your attention to the administration's proposals with respect to sections 401(k) plans.

Even the May proposals, to the extent that they would have perhaps been more generous than the most recent proposals—in May the administration proposed to preserve section 401(k) plans—I would like to point out that the complexity associated with that proposal was extraordinary.

Section 401(k) contributions would have had to have been tested under the overall limits on plan contributions in section 415 of the code, including a new 15 percent of individual compensation limit.

Additionally, we would have had to test for a separate $8,000 per capita cap.

In addition to that, we would have had to suffer or we would have had to live with a new stricter average deferral percentage test to be calculated on each individual employee. In addition to that, we would have had a new test imposed on matching contributions to the extent that any of these plans provided them and an IRA offset.

It strikes us that that is not simplicity by anybody's definition. Of course, whatever the complexity is that was being proposed by the administration in May is less mystifying or less troubling to us than its most recent proposal, in August, that the section 401(k) simply be abolished, notwithstanding their demonstrated popularity with a broad segment of the employees in this country.

I would point out to you, Mr. Chairman, that one of the reasons that it may be difficult to generate data on section 401(k)'s is that we have really only had a section 401(k) plan—and I speak now for Mobil as well as for most other section 401(k) plans—for something less than 3 years. So the data lags.

We are dealing with a phenomenon that really first blossomed in 1983 and we are not too far along. The data will lag. It's difficult to know what is going on when we're dealing with such a short timeframe.

In addition to that, we share your concerns with respect to the treatment that the administration would extend to distributions from these plans. We think that the lump-sum option is clearly, for many employees, a preferred mode of distribution.

It strikes us that what is implicit in the tax proposals of the administration is what might be referred to as a model distribution scheme: all employees, all retirees should receive their benefits in a particular form because someone here in Washington has made that decision.

It strikes us that one of the advantages of the present system is that individual retirees are able to elect to receive their benefits in a form that is appropriate to their particular needs. To the extent that lump sums are available, to the extent that employees have elected to receive them we would submit to you that they have made a conscious decision as to what is in their best economic interest.

We would ask that Congress go very slowly in making a single decision here in this town: that those cumulative decisions, those individual decisions are necessary inappropriate. We think that is not the case.

Furthermore, we would like to suggest to you with respect to the arcane and difficult coverage and discrimination tests that are being proposed by the administration, we would not stand up here today and submit to you or defend before you the concept that anyone should be allowed to discriminate in favor of the highly paid in any of these plans.

We share the conviction that discrimination should be prohibited.

We do not believe that the rules, as proposed by the Administration, will reach the generally accepted definitions of discrimination in favor of the highly paid in these plans. We are convinced that although the tests may be simple to administer by the agency, but it is extremely difficult for any single plan to comply with them.

We have not found, in our efforts of the last few months, a single major plan that can meet these tests. So it seems to us that if you pass this kind of rule you should expect major dislocation among both small plans as well as the larger plans.

In conclusion, we would like to suggest to you that any policy, such as the one we are now confronting, which has the effect of discouraging capital formation, discouraging savings for retirement, making it more difficult for people to put money away and save and provide for their own security at retirement is ill-founded and starts us off in the wrong direction, and will put us in a very bad spot down the road, so to speak.

Mr. Chairman, I will conclude my remarks now. Thank you very much.

[The prepared statement of Mr. Anderson follows:]

ERIC

THE
ERISA
INDUSTRY
COMMITTEE

ORAL STATEMENT OF

VANCE J. ANDERSON, ESQ.

CHAIRMAN, RETIREMENT SECURITY COMMITTEE
THE ERISA INDUSTRY COMMITTEE

DELIVERED BEFORE

THE COMMITTEE ON LABOR AND HUMAN RESOURCES
UNITED STATES SENATE

HEARINGS ON THE PENSION POLICY IMPLICATIONS
OF THE PRESIDENT'S TAX PROPOSALS
ON FRINGE BENEFITS AND RETIREMENT SAVINGS

TUESDAY, OCTOBER 1, 1985

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Mr. Chairman, I am Vance Anderson, Employee Relations Counsel for Mobil Oil Corporation, and I am appearing here today as Chairman of the Retirement Security Committee of ERIC, The ERISA Industry Committee.

The ERISA Industry Committee represents the employee benefit plans of the nation's major private sector employers. As sponsors of plans benefiting over 9 million workers and retirees we share with this Committee a vital interest in national policies affecting the treatment of pensions, savings plans and other benefits which provide economic security to American workers and their families.

All too often, discussions about these policies are subsumed in the quest for tax revenue. As a result, thoughtful discussions about retirement security policy take a back seat to tax policy changes. That is something ERIC regrets and that is why we are especially grateful to you, Mr. Chairman, for holding this hearing today.

I will concentrate my remarks today on the threat to private sector benefit plans posed by current tax reform legislation -- especially provisions which would jeopardize pension, profit sharing and savings plans maintained by private sector employers. I should say at the outset that it is the firm conviction of ERIC members that these proposals would send federal policy on savings and retirement income in a perilous and inappropriate direction.

The limits, restrictions, cutbacks and curtailments that are laced throughout the President's tax reform proposals dealing with pensions and retirement security plans will have the following consequences:

-- reduced benefit levels for workers currently covered, the vast majority of whom earn less than $25,000 per year;

-- reduced funding for qualified plans, a result that will not only reduce plan security but diminish the pool of capital available for new business investment and job creation as well;

-- reduced retirement income security for millions of workers who will either lose their current coverage or opt not to participate in a system that ties up their savings in a financial straightjacket;

-- greater economic costs for the remaining participants and the prospect of greater cost to the government if public pressure builds to replace benefits lost from the private sector system.

These consequences -- often overlooked in the debate about tax reform -- would disrupt for no good reason the present employee benefits system. That system has proven its worth by successfully covering the workers targeted under current law. In 1983, 56 percent of all nonfarm workers had a pension plan and at larger companies nearly all workers are covered. Of those not covered, nearly two-thirds were under the legal participation age, worked less than 1000 hours a year, had less than a year on the job, or were self-employed. By law and practice, benefits are available to a broad cross section of the workforce.

Given the widespread coverage and participation and given the distribution of benefits across income levels, the first goal of public policy on pension and savings plans should be to build on current success rather than jeopardize programs that work. Yet many of the proposals would threaten the efficiency and flexibility (if not the existence) of current private sector plans..

Harsh new rules would apply to the administration of all benefit plans. Far from simplifying the current maze of federal regulations that govern these plans, current tax reform proposals would actually add new layers of complexity. For example, under the Administration's May proposals, 401(k) contributions would have to be tested under the overall limits on plan contributions in Code Section 415 including a new 15% of individual compensation limit, under a separate $8000 cap, under a new, stricter average deferral percentage (ADP) test calculated on an individual employee basis, a new test on matching contributions, and an IRA offset. So much for "simplicity."

Of course, the complexity proposed by the Administration in May is less mystifying than the sudden reversal in August -- the proposed elimination of Section 401(k) altogether. The 401(k) plan has produced a revolution in worker savings. People who have not and would not participate in individual savings arrangements (such as IRAs) or even other employer-sponsored qualified plans have found in the 401(k) plan a vehicle that not only encourages a disciplined approach to savings, but that offers long-term security for retirement.

There is much concern being expressed about an appropriate tax policy for qualified retirement and savings plans. At the heart of the Administration's new taxes on preretirement distributions, the proposed repeal of favorable tax treatment for lump-sum distributions, and even the proposed repeal of Section 401(k) is a view that the government should decide how and when workers use their savings. This Administration, curiously enough, would impose a "model" on workers who receive the tax advantages of savings through qualified plans: in general, workers will be required to receive monthly annuity-form benefits after a specified age. Failure to abide by this model will result in a series of economic penalties that would greatly diminish the assets of workers involved and limit their ability to provide for retirement security.

So not only would the Administration proposals cut retirement benefits for plan participants, but they would eliminate options that workers now have when they plan their retirement. Workers who choose (or who are forced) to take early retirement often need access to their plan assets to start a retirement business, as protection against inflation, to handle emergency financial contingencies, or to make other investments that will enhance their long-term economic security. In short, these workers -- most workers -- need flexibility. That is what the current system provides. That is what the Administration proposals would limit, if not abolish.

Workers would be discouraged from receiving their savings in one lump sum and they would have virtually no access to their savings prior to retirement. People at all income levels have made long-term decisions on the basis of current rules. They have a basic, fundamental, equitable right not to be penalized for their careful planning by abrupt changes such as those in the Administration's plan.

Many younger workers and lower paid workers, for example, now consider their company-sponsored savings and profit-sharing plans the best way to accumulate capital for the future. The proposals now under consideration reflect a fundamental distrust of these workers: the assumption behind shutting off access to plan savings is that the assets will be consumed rather than saved for retirement needs.

Available data, however, shows that this is only true for small dollar distributions. For distributions over $5000, 60% is saved; for distributions over $10,000, almost 80% is saved; and for distributions above $20,000, almost 90% is saved.

Mr. Chairman, I would like to touch on one other area of great concern to ERIC members. The Administration's plan also proposes to eliminate the current IRS ability to deal with individual facts and circumstances in testing for nondiscriminatory coverage. The proposals would institute instead new mechanical tests both to determine who would be considered in the "prohibited group" and to determine whether a plan covers sufficient numbers of other employees to be tax qualified.

In operation, however, these mechanical tests produce a hodgepodge of results. It would be possible to have 100% of a company's employees covered under pension and savings plans and have several plans fail this coverage test. At the same time, circumstances which under current law would raise questions of discrimination might escape scrutiny entirely under this proposal. It would be difficult to overemphasize the harm that would be caused by passage of this mechanical rule: every plan we know of would fail the test, regardless of the fact that they do not discriminate. Massive plan disqualification will do nothing to promote equity in plan coverage -- the proposed test is far worse than current law.

Mr. Chairman, in conclusion, pension, profit-sharing and savings plans help provide much of the capital necessary for expansion and growth of the national economy. Changes in policy that discourage this kind of capital formation are shortsighted.

Every dollar set aside in a qualified plan is eventually subject to taxation. Most of current tax deferrals are eventually recouped by the government, and this recoupment would be increased under a structure of fewer brackets. In addition, as our population ages and lives longer, adequate savings for retirement and future financial needs through employer-sponsored plans stand as one of the best ways to avoid more costly dependency on taxpayer-financed government programs.

Nearly twice as many taxpayers benefit from tax incentives for pension, profit sharing and savings plans than the number of taxpayers who make use of the deduction for home mortage interest payments. If we agree that sound social policy embraces favorable tax treatment for home ownership, then surely savings for retirement and major financial needs in the family also rank as an area of social policy that should not become embroiled in the current debate over tax reform.

The ERISA Industry Committee and many employers and organizations active in the benefits field oppose these proposed restrictions and limits on private sector retirement, savings and benefit plans. Tax reform is a worthy goal, but proposals to dramatically restructure retirement income and benefits policy do not belong in a tax reform proposal. The provisions in the Administration's proposal dealing with pension, profit-sharing and savings plans should be excluded from tax reform legislation and considered in a forum more appropriate to the fundamental questions of retirement income policy which they raise.

ERIC and its member companies will be ready and willing to work with this Committee, and other Committees of the Congress, in fashioning sensible, efficient, and flexible national policies dealing with retirement income security.

ERIC

The
ERISA
Industry
Committee

WRITTEN STATEMENT OF

VANCE J. ANDERSON, ESQ.

CHAIRMAN, RETIREMENT SECURITY COMMITTEE
THE ERISA INDUSTRY COMMITTEE

DELIVERED BEFORE

THE COMMITTEE ON LABOR AND HUMAN RESOURCES
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TUESDAY, OCTOBER 1, 1985

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INTRODUCTION

I am Vance J. Anderson, Employee Relations Counsel for the Mobil Oil Corporation. I am appearing today as Chairman of the Retirement Security Committee of ERIC, The ERISA Industry Committee.

The ERISA Industry Committee, referred to as ERIC, represents the employee benefit plans of the nation's major private sector employers. As sponsors of plans benefiting over 9 million workers and retirees, we share with this Committee a vital interest in national policies affecting the treatment of pensions, savings plans and other benefits which provide economic security to American workers and their families.

I will today concentrate my remarks on changes affecting employee pension, profit sharing and savings plans, although we also share with others who are appearing before you concerns about proposed changes in the treatment of other forms of employee benefits.

BACKGROUND

Before we examine the impact of current tax reform proposals on pension, profit sharing and savings plans, a general understanding of current programs is necessary.

First, who is covered by tax qualified plans? In 1983, 56% of the 88 million nonfarm workers had a pension plan. That is over 49 million workers and their families. 70% of workers under age 65 and meeting ERISA participation standards were covered. 82% of employees in larger firms were covered. More than three quarters of workers with pension coverage earned less than

$25,000 in 1983. These same workers held over 70% of all vested benefits. Clearly, tax reform proposals which affect qualified pension and savings plans have a major impact on the lives, security and well being of middle income families.

Of all those workers **not** covered, nearly two-thirds were under the legal participation age, worked less than 1000 hours a year, had less than a year on the job, or were self-employed. Others apparently are concentrated in small firms who cannot afford qualified plans and who likely are not affected by a tax-incentive system since they have little or no taxable income.

Current coverage, therefore, is broad, covers the majority of those targeted for coverage under current law, and, given the concentration of coverage among those making less than $25,000, can in no way be construed as an extravagance benefiting the wealthy. The current broad coverage under a totally voluntary private pension system is a post-World War II phenomenon which is a testament to the support of the current system by previous Administrations and Congresses.

Second, who actually receives or can expect to receive benefits from the current system? Although the pension system is only now beginning to mature, about 30% of all elderly now receive pension benefits. Those benefits account for 15% of the total income of those over age 65 -- and 45% of the income of those who do receive pensions. Among those **now** retiring, 56% of couples and 42% of unmarried persons receive pension income. 75% of younger couples and 65% of singles can expect to receive a pension benefit when they retire in the future. Calculations of coverage in this area often understate the actual impact of current pension coverage since pension and savings plan distributions not in annuity form often are not included in current tabulations of pension income.

About one third of the workforce has little or no individual savings other than that in their employer sponsored pension and savings plans.

Some may look at these numbers and call the glass partly empty; we see a glass rapidly getting more full. Pension benefits are important to a large sector of the population and the impact of the pension system on American retirement is expected to grow dramatically in the coming years.

Third, why are there so many different plans? The current system offers a variety of plans that meet the needs of various workers and the varying resources of sponsoring employers. In defined benefit plans, a relatively secure employer asumes the risk of investment and provides employees with a pre-established benefit. In defined contribution plans, the employee assumes more of the risk of investment but may gain faster vesting and more individual flexibility. Profit sharing and thrift plans share the burden of saving between the employer and employee but also provide incentives for the employee to save in a disciplined manner, resources to meet individual needs throughout one's life, and a savings pool that will convert to retirement needs at the appropriate time.

Fourth, what is the cost to the government of the current system? The FY 1986 tax expenditure estimate for pension plan contributions and earnings is $55.1 billion. However, taxes are paid on all qualified plan funds at some point since workers pay taxes on all plan distributions not previously taxed. Even accounting for the possibility that individuals could be in a lower bracket when the tax is paid, workers now entering a pension plan will eventually repay from 60 to 82% of every $1.00 deferred. This repayment would increase under a system of fewer brackets.

In computing the cost of the current system to the government, policymakers must also calculate the replacement cost if the loss of private sector coverage resulted in demands for increased government protections.

Pension, profit-sharing and qualified savings plans also represent an investment of $1 trillion in the economy -- the largest source of business investment capital and the source of more than one third of all venture capital last year. If pension and savings plans are diminished, the loss of savings and usable capital would reduce economic growth, worker productivity, and eventual taxable income.

Fifth, how important are employer sponsored pension and savings plans to employees? A 1985 survey commissioned by ERIC and APPWP and conducted by the respected public opinion research firm of William R. Hamilton found that 80% of workers believe it is important to have a pension or profit sharing plan where they work. 82% said many employees would fail to provide for their own needs if employers did not provide benefits to employees and that the government would end up paying in some way. A majority of those surveyed opposed taxing employee benefits in order to lower overall income tax rates.

POLICY ARGUMENTS

Some policymakers in the Administration and Congress argue that the current employee benefits system is inequitable, results in a loss of federal revenue, and/or represents an intrusion on individual choices in the free-market. Defenders of the system dispute these arguments and point to the advantages of group benefit protection, wide coverage under the current system, equitable distribution of benefits, and the importance of private/ public sector partnership in meeting the economic needs of American workers, and in encouraging savings.

A summary of the arguments follows:

Self-administered Arrangements v. Group Protection

Those favoring an individual or self-administered approach to benefit protection argue that in a free-market economy, it is better to give individuals the responsibility of making their own arrangements for insurance against unforeseen risks and financing their own pensions, profit-sharing and savings plans for retirement.

On the other hand, access does not equal equity. Even if individual arrangements (such as IRAs) are available to workers, data show that some workers are unable and choose not to participate.

Group plans offer greater security, lower costs, more convenience, and a disciplined approach to savings and risk protection. Group plans are professionally designed and administered. Group plans by law must benefit a non-discriminatory group of employees, thus ensuring greater equity.

Horizontal Equity v. Broad Coverage

Some argue that it is unfair that taxpayers with access to certain benefit programs receive a tax preference when other individuals must purchase benefits with after-tax dollars.

On the other hand, most employees with a substantial attachment to the workforce are covered under current employer-provided benefit plans. Penalizing a vast majority of workers for the coverage they enjoy would be less equitable than providing incentives and alternatives for those who do not have coverage.

Tax Simplicity v. Convenience

Some argue that the complicated tax code is a source of frustration to a majority of Americans. Eliminating a range of incentives in the tax code, including those dealing with employee benefits, would make the system simpler.

On the other hand, current proposals do not, in fact, make the tax system simpler for workers. For instance, employees are not currently required to keep track of the value of their employer-provided benefits nor handle the details and paperwork associated with plan administration. If they were required to pay taxes on benefits or shop for their own coverage, they would encounter greater complexity and would need to acquire additional information and expertise to make the right decisions and additional income to purchase higher-priced benefits.

Moreover, proposed changes in the rules governing the administration of benefit plans would make them both more difficult and more expensive to maintain.

Tax Progressivity v. Equitable Participation

Some argue that tax-favored employee benefits primarily benefit the upper-income and result in unfair tax advantages.

But this argument is not true. Employee benefit plans are definitely not "fringes" or "loopholes" for the wealthy. Current law requires that plans benefit a non-discriminatory group of employees and as a result, three-quarters of those participating in benefit plans earn less than $25,000 per year.

Base Broadening v. Hidden Tax Increase

Critics of private sector benefits argue that non-wage benefits are growing as a percentage of total compensation and the amount of income available for taxation is decreasing. Given large budget deficits, the government cannot allow benefits to escape taxation.

However, less than 10% of an employee's total compensation package --including salary, paid absences from work, employer contributions to government programs (Social Security, unemployment insurance, etc.), and tax-favored employee benefits (pensions, insurance, etc.) -- receives any favorable tax treatment.

In the case of pensions and retirement savings, the employee pays taxes on a deferred basis when the benefit is received. Given the broad coverage of current benefit programs, taxing benefits is simply a tax increase and not "base broadening."

Retirement v. Non-Retirement Savings

The Administration and others argue that tax preferences given to savings in employer-sponsored benefit plans should be limited to retirement "income" and benefits should be received in a monthly income stream after retirement begins.

Yet, given the low rate of savings in the United States versus other industrialized nations, national policy should encourage retirement savings. An estimated 29 percent of workers have no savings or assets beyond what they accumulate in employer-sponsored retirement, profit-sharing and savings plans. For most individuals, the savings accumulated in these plans will be used for retirement security once the employee approaches retirement age.

In addition, new restrictions or tax penalties for receiving pre-retirement distributions from savings plans will discourage many workers -- especially younger and lower-paid employees -- from participating in company retirement savings plans.

The fact is few workers are willing--or feel they are able--to lock in savings for retirement with virtually no access to those funds for major life contingencies. It is also a fact that most workers utilize retirement savings for retirement and the greater the amount of money in the plan the more likely it will be utilized for retirement.

Moreover, limiting distributions to retirement "income" fails to account for retirement "security;" for example, purchase of income property, a retirement business, a retirement home or providing for increased medical costs and other uses of distributions to most individual needs.

Deficit Reduction v. Replacement Costs

Some argue that large federal budget deficits require additional revenue-raising measures. Employee benefits are a source for these revenues.

In the future, however, these same workers who are now covered by private plans would most likely turn to the government for their financial needs -- especially as they neared retirement with insufficient savings for living and medical expenses. The "replacement costs" to taxpayers in the future would more than offset the temporary increase in revenue from taxing benefits today.

Public Sector v. Private Sector Responsibility

Some critics of private sector benefits argue that the nation would be better off with publicly financed national programs for medical expenses and retirement income instead of plans operated by private sector employers.

Yet, our nation has preferred variety and flexibility in protecting individual citizens against the economic consequences of death, injury, illness or poverty in retirement. Benefits have traditionally been viewed like pay -- something to be decided between employer and employee. Dismantling the private sector employee benefits system, for whatever reason, would disrupt a fundamental social covenant between workers, employers and their government.

ADMINISTRATION'S TAX PROPOSAL

The Administration's May 1985 tax reform proposal would make dramatic changes in the Internal Revenue Code. Some ERIC companies do not support the overall plan. Other ERIC companies have applauded the plan or support the general effort for tax reform. Whatever our members' individual positions on tax reform, however, ERIC companies have been united in their opposition to provisions that would dramatically alter the operation of basic pension, profit sharing, and/or savings plans, some of which have been in operation for a hundred years. The provisions we are concerned about are estimated to produce relatively insubstantial revenue.

New coverage test for all qualified pension and savings plans (Chapter 14.09 of Administration's Tax Proposal):

Current Law: Under current law, a plan must meet certain percentage coverage requirements or be found by the Commissioner of the Internal Revenue Service not to discriminate in favor of officers, shareholders or highly compensated employees as to benefits or contributions. Any plan must cover a broad cross section of employees in order to be qualified as nondiscriminatory. The test is structured to provide basic guidelines while providing a mechanism for the IRS to deal with specific facts and circumstances.

A. New income distinction among participants:

Proposal: Under the Administration's plan the definition of the highly compensated -- or the "prohibited group" -- would be a mechanical definition that generally would include anyone who either earned at least $50,000 a year, was in the top 10% of payroll for the entire company or who was related to someone in these categories.

Concerns: This mechanical prohibited group test will produce problems and unusual circumstances which the Congress will want to review. Specifically, in a company where salary ranges are fairly high, the prohibited group may include a fairly large percentage of the workforce, not just highly compensated employees. In a company where salary ranges are fairly low, the prohibited group will include individuals making $30,000 or less. In fact, it is possible for someone making $21,000 to be in the "prohibited group" under this test.

Companies who have large numbers of rank and file employees who are related to each other have absolutely no means of determining who must be added to the "prohibited group" because they are married to or otherwise related to someone who falls within the bounds of this mechanical test.

Many large companies also would have to aggregate data from separate payroll centers, information which may be impossible to compile for the previous three years, as the proposal would require.

This mechanical definition of a "prohibited group" is not likely to produce a balance between coverage of highly compensated individuals and other employees and is more likely to produce a hodge-podge of results that bear little or no relation to the policy objective of ensuring that rank and file employees are adequately protected.

B. New percentage coverage test:

Proposal: Once the "prohibited group" is established for a company, it is then used to determine whether a plan will be deemed discriminatory in its coverage under a second mechanical test, which, in general, works as follows: The company must calculate the percentage of the prohibited group which is covered under the plan being tested. It must also calculate the percentage of all other employees which are covered under the same plan. The coverage percentage for the prohibited group cannot exceed 125% of the coverage percentage for all other employees in order for the plan to be tax qualified. For example, if 95% of the prohibited group is covered under a plan, then 76% of all other employees must be covered under that plan in order for it to qualify.

Concerns: It would be possible for a company to cover 100% of its employees under qualified pension and savings plans and fail this coverage test. Indeed, any company, large or small, which has more than one plan for its employees could easily fail this test, or could pass it one year and fail it another as the composition of the workforce changes.

Companies have different plans for different segments of their workforce in order to reflect competitive labor markets, different lines of business, different geographic locations, different worker needs and for similar reasons. This mechanical coverage test does not allow for these differences. The test could distort business decisions, result in the establishment of uniform plans which do not suit any segment of an employer's workforce well.

It would be difficult to overemphasize the harm that would be caused by passage of this mechanical rule. Large numbers of established plans, some of which have been in existence for decades and which collectively cover tens of millions of workers and their families, are finding they would not qualify under this proposed scheme even where in fact they are not discriminating.

Moreover, under this mechanical rule circumstances which under current law might raise questions of discrimination might escape scrutiny entirely .

Finally, if the primary objective of this proposal is to provide ease of administration for the Internal Revenue Service, we would suggest that that goal would be inappropriate and elusive. Millions of employees should not have their benefits jeopardized simply to provide an easier rule for the IRS. In addition, the establishment of such a rule will most likely rapidly lead to "exceptions" for comparable plans, different lines of business, different geograpic locations, and other legitimate employee needs which will prove no less complicated than current law to sort out.

Revenue: This change is estimated to produce no additional revenue for the tax reform plan.

ERIC Position: ERIC strongly urges that this item be removed from the consideration of the tax reform proposals so that a more workable approach can be carefully constructed. ERIC would be pleased to work with this Committee and with Treasury to attempt to find answers to any specific problems that they may wish to address in this area at a later date.

Restrictions on employee profit sharing and savings plans (Chapters 14.02 and 14.04 of Administration's Tax Proposal):

Current Law: Qualified pension plans provide payments to beneficiaries generally upon disability, death or separation from service. In the private sector these benefits generally are employer funded. Profit sharing, thrift and other employee savings plans also provide substantial retirement income to employees and are designed to encourage the employee to put away money over his or her lifetime.

Proposal: Tax favored status would be reserved only for employee savings which is generally restricted to supplying monthly retirement income. This would be accomplished by (1) denying employees access to their own after-tax contributions to a plan until all taxable money had been withdrawn so that any money withdrawn would, first, be subject to income tax; (2) eliminating 10 year averaging, special capital gains treatment and deferral of the unrealized gain on employer securities, which currently help to prevent a worker from being pushed up in the income tax brackets by receipt of a plan distribution; (3) subjecting distributions prior to age 59 1/2 to a 20% excise tax on top of federal and state income tax (with the excise tax reduced to 10% in some instances); and (4) subjecting distributions over $112,500 to an additional 10% excise tax on top of other income and excise taxes.

Concerns: These restrictions represent a major change in national savings policy which has supported profit sharing and thrift plans since the 1920s through the tax code. The restrictions will result in dramatically reduced savings among workers, who will not be able to "lock their money up" for decades. It will be extremely difficult to get younger workers at any income level to participate in company savings plans.

Treasury argues that the excise taxes are not penalties but just "recaptures" of the tax privileges when money is not used strictly for retirement income. However, the excise taxes and other penalties in combination will present both real economic loss and an insurmountable psychological barrier against savings for most workers. These disincentives also ignore the fact that a disciplined savings program and accumulation of savings throughout one's life affects retirement security just as much as a strictly defined retirement income stream.

Concerns have been raised that money distributed to employees before retirement (such as when an employee leaves a company) is spent rather than saved. However, available data shows that while this may be true for small amounts of money, of distributions over $5000 almost 60% is saved; of distributions over $10,000 almost 80% is saved; and of distributions over $20,000, almost 90% is saved.

Moreover, focusing on the fate of money cashed out of plans before retirement ignores the more important question of the money which remains in plans and eventually becomes an important part of a worker's retirement pool. This is a critically important consideration for the millions of workers who do not have, and are not likely to have, substantial savings from any other source.

Revenue: The Administration's proposal shows revenue gains from these changes (as recalculated by the Joint Tax Committee) beginning at $1.1 billion in 1986 and reaching $5.9 billion in 1990, totalling $14.8 billion over the five year period. Most of the revenue gained from the proposed new taxes on qualified plan distributions -- $10.8 of the $14.8 billion -- would come from repeal of the three-year basis recovery rule. This rule affects the timing of taxation on amounts distributed in annuity form from contributory defined benefit plans. These plans are prevalent among state and local governments.

The remaining $4.0 billion revenue would come from individuals who did not -- or most likely could not -- conform to the IRA rollover and payout schedule envisioned by the President's plan. In all likelihood, the persons most heavily hit will be middle and lower income workers who will not be able to avoid the proposed tax increases through the IRA rollover device. the principal impact of these changes is to impose additional taxes on the savings of lower and middle income workers who are unlikely to have significant savings outside their employer plans to meet needs not foreseen in the tax reform plan.

The Administration's plan would expend $4.1 billion over the same five year period in an IRA expansion that, consistent with past experience, will be available only to higher paid individuals who can afford, and are otherwise motivated, to divert larger amounts of current income.

ERIC Position: **Few policy choices facing this Committee will have as long-reaching an effect on American workers for as little revenue as would a decision to reverse 70 years of support for employee savings plans.** ERIC strongly urges the Committee to preserve the current tax treatment of these plans, both in terms of providing employee access to funds to meet needs which arise over a lifetime and in terms of providing flexibility in the form of payment of funds from qualified plans.

Lump sum distributions from a qualified plan do not work against the economic security of workers. The current system has been successful in providing the bulk of its accumulations to employees for retiement. It does this in part by giving employees flexibility in meeting other needs, by encouraging savings for many purposes, and by providing a disciplined framework for savings. National policy must be guided by patterns of practical experience and not by isolated exceptions to the rule.

Restrictions on 401(k) plans (Chapter 14.06 of the Administration's Tax Plan); **Repeal of Section 401(k) plans** (August 1985 amendments to Tax Plan):

Current law 401(k) plans are tax qualified profit sharing or stock bonus plans which give an employee the option of receiving cash or of having the employer make a contribution to the plan. If the employee chooses to have the employer make a contribution to the plan, he is not taxed on the contribution until he receives a distribution from the plan. 401(k) plan contributions are covered under the general rules limiting contributions to pension plans (I.R.C. Sec 415) and, in addition, contributions on behalf of the higher paid one third are limited by contibutions made on behalf of the lower paid two thirds. In many plans, elective contributions are matched by the employer.

Proposal: The President's original tax proposal (May 1985) limits contributions to 401(k) plans in several different ways, only one of which is a special overall cap. Elective contributions would be limited to $8000 offset by IRA contributions. A new "prohibited group" would include those earning over $50,000, or the top 10% of payroll, and those "related to" these individuals. There would be a new coverage standard similar to the one for qualified plans (see prior discussion) except that it would be limited to employees "eligible" for the plan. There would be a new, stricter average deferral percentage (ADP) test which would be applied on an individual basis. Employer matches would sometimes be included in the calculation of the ADP test. There would be a 10% excise tax on excess contributions. No distributions would be allowed before death, disability or separation from service.

The Administration subsequently revised the President's plan in August 1985 by proposing, in a letter from the Treasury Secretary to the Chairman of the House Ways and Means Committee, that Section 401(k) of the Tax Code be repealed outright. Even if elimination of popular 401(k) plans seems unlikely, the proposed restrictions might accomplish the very same result.

Concerns: The proposed changes severely restrict the viability of 401(k) plans. Distributions not only would be denied for any form of hardship but also would not be available after age 59 1/2 unless the employee quit his or her job. These restrictions on potential access to funds will diminish the attractiveness of 401(k) plans for younger workers. At the same time, the proposed cap on elective contributions and the restrictions placed on contributions through the ADP and other new rules are largely duplicative of each other, adding unnecessary complications to the operation of these plans. 401(k) contributions would have to be tested under the 415 limits (including a new 15% of individual compensation limit), the special cap, the new ADP test, the new matching test, and the IRA offset in order to qualify for favored tax treatment. Moreover, there is as yet considerable confusion about how the proposed rules in the 401(k) area actually can be expected to work.

As far as the proposed repeal of 401(k), there is a nearly unanimous feeling among ERIC member companies that such a decision would fly in the face of virtually every national policy objective that this Committee or Congress itself would wish to encourage: 401(k) plans demonstrably enhance retirement security by encouraging many workers, especially younger and lower-paid employees, to participate in the private sector retirement savings system. Many of these same workers might not have available any other qualified plan nor are they more likely, according to available statisitics, to be making their own arrangements for retirement income through an IRA. Second, 401(k) plans enhance the objectives of increased personal savings and capital formation by giving many workers an avenue for savings that would otherwise be bypassed in favor of current consumption. It would be hard to design a more attractive plan (from both the employer's and the employee's perspective) which also has the significant merits of increased retirement income security, expanded coverage under private sector arrangements, growth of assets available for new investment and jobs, and enhanced convenience and discipline for long-term personal savings.

Revenue: Approximately $15.9 billion is estimated to be raised from the proposed repeal of 401(k) plans over the five-year period FY 1986-90. That amount is $11.6 billion more than the $4.3 billion that would have been raised by the May 1985 proposals to limit and restrict 401(k) plans and to deny use of these plans to state and nonprofit organizations.

ERIC Position: Total repeal of 401(k) plans would represent a step backwards in America's effort to protect the retirement income security of its aging citizens.

401(k) plans are viable and important savings vehicles and they should be made useful and encouraged. They are more beneficial than other vehicles for middle and lower income individuals and they are covered under overall limits on pension plan contributions. They may be particularly well suited for expansion of coverage into areas where coverage is now weak or lacking, especially among small companies where the vast majority of uncovered workers are employed. They also offer an attractive supplement to other pension coverage without exceeding overall Internal Revenue Code limits. Moreover, tax expenditure numbers do not account for the fact that taxes will be paid on all funds in 401(k) plans at the time the benefits are received by the worker.

Other proposals:

A. Change in 15% of aggregate compensation limit:

Current law: An employer can deduct contributions to profit sharing and stock bonus plans so long as the contributions do not exceed 15% of the aggregate compensation paid to covered employees.

Proposal: The aggregate limite would be replaced by a limit of 15% of an individual's compensation.

Concerns: The individual limit would effectively lower contributions for lower paid employees nearing retirement in plans which have a length of service factor in the contribution formula. This would be especially harmful for employees who already have substantial service in such plans and would unnecessarily preclude flexibility in design of retirement plans.

ERIC position: This provision should be removed from any proposed legislation.

B. New limit on employee contributions:

Current law: The lesser of one half of an employee's own after-tax contributions to a qualified plan or the employee's contributions in excess of 6% of compensation are included in overall limits on contributions to qualified plans.

Proposal: The 6% of compensation "carve-out" would be eliminated.

Concerns: Contributions made on an after tax basis by employees should be encouraged. This proposal imposes an unnecessary restriction and disincentive on such contributions.

ERIC position: This provision should be removed from any proposed legislation.

CONCLUSION

ERIC believes that the proposed changes affecting pension, profit sharing, and employee savings plans should be removed from the tax reform proposals. Future revenue collections or potential rate reduction would not be substantially affected. In those few areas were some change may be required, ERIC believes alternatives can be found which would be less detrimental and less complex than those of the current proposals.

Current national policy supports a system of economic security for most American workers through benefit programs maintained on their behalf by employers. Incentives in the tax code encourage employers to provide pension, profit sharing and savings plans and other benefit programs for the welfare of individual workers and their families.

The policy is successful and has enjoyed support from national

Administrations and Congresses throughout this century. A majority of full time workers at all income levels are covered by basic benefit programs. More than three-quarters of those covered by benefit programs make less than $25,000 a year -- benefits are not "fringes" or "loopholes" for the highly-compensated. The benefits system is flexible, diverse and efficient, accommodating differences in industry structure, family structure, labor force and demographics.

Despite its success, the private sector benefits system, beginning with the 1982 and 1984 tax acts (TEFRA and DEFRA) has come under fire. A range of current proposals, including the Administration's May 1985 tax reform package, would impose new and/or higher taxes on savings and benefit programs and new limits and restrictions on those who participate. New taxes and restrictions would hit employees at all income levels in the workforce and discourage savings. Higher taxes on distributions from savings and retirement plans would erode their value to individual employees,and new restrictions would limit the amounts that employrs can set aside on an employee's behalf.

Some policymakers argue that the current private sector benefits system is inequitable, results in loss of federal revenue, or intrudes on individual choices in the free market. Defenders of the system dispute these arguments and point to the advantages of group benefit protection and security, wide coverage under the current voluntary system, equitable distribution of benefits, and the importance of private/public sector partnership in meeting the economic needs of American workers.

The long term impact of proposed changes in the national policy on employee benefits requries careful evaluation. Reducing the attractiveness of currentprograms culd lead workers (especially those who are younger) to drop coverage or reduce savings. In future years, pressure on government to replace benefit programs could result in higher net expenditures by government and an increased burden on future taxpayers. The principal source of investment capital for business (pension, savings and profit sharing funds) could be jeopardized.

ERIC urges this Committee to protect the private sector employee benefits system by removing harmful and unnecessary changes in employee benefit law from tax reform consideration.

Senator Nickles. Mr. Anderson, thank you.

Mr. McCormick.

Mr. McCormick. Mr. Chairman, I'm Deane McCormick. I'm president of the Association of Private Pension and Welfare Plans. I'm employed by Litton Industries where I have responsibilities in the tax and employee benefit area.

I might also observe that my prior training to appear here today involved graduation from the University of Oklahoma.

Senator Nickles. That speaks very well of you.

Mr. McCormick. The APPWP welcomes this opportunity to present its views on those aspects of the President's tax reform program which affect employer-sponsored pension and welfare benefit programs.

The APPWP is deeply concerned that the search for revenues in the context of tax reform will, in the coming months, become so intense that these social and economic policy values will not receive the attention they deserve.

Accordingly, we believe it is especially important for this committee to make its voice heard in the debate which will determine the retirement security of American workers. In so doing, we urge this committee to keep in mind three broad policy themes.

The first is voluntary action. The success of our current broad-based private pension and welfare benefit system rests upon the voluntary actions of employers, and often employees, to establish and maintain such programs.

In recent years, however, we have—perhaps unintentionally—begun to threaten this beneficial but voluntary system by legislation, which cuts back on benefits often in the name of deficit reduction and occurs with such frequency that many employers are beginning to find the revised rules to be so restrictive and so complex that the need to establish and maintain employee benefit plans is outweighed by the constraints of administrative costs and executive time involvement.

We need to be realistic. If we are going to continue to rely on voluntary decisions, we must strengthen the incentives and not sacrifice much of what is left of them in the name of revenue neutrality.

The second thing to keep in mind is the importance to our benefit system of basic core employee benefits. It is essential that we retain the private sector security net that was developed over the past 40 years and that these core benefits be provided on a collective basis by employers, rather than leaving each employee to make his or her own arrangements.

The most effective means of assuring an adequate standard of living with the greatest number of older Americans is to continue and strengthen the incentives for employers to provide for their employees' retirement.

Employer-sponsored retirement plans are broad-based, providing coverage to a vast number of employees at all income levels, including those who do not have sufficient current income to cover savings in addition to basic living expenses.

In addition, employer-sponsored retirement plans are generally more cost effective than individual programs. There are efficiencies of scale and flexibility of investment. Moreover, they provide a cheap source of capital necessary for national economic growth.

The third major policy value, flexibility, stems from and is made necessary by the diversity of America's employers and their workers. This necessary concept of flexibility has two different policy consequences.

First, employers have different needs and abilities. For example, we now permit two basic types of qualified retirement plans: defined-benefit plans and defined-contribution plans. Both should be preserved for the simple reason that some employers find that defined-contribution plans, with the contribution often expressed as a percentage of profit, to be the more affordable of the two.

Similarly, employees should also have flexibility to provide for greater retirement benefits such as is permitted under the section 401(k) plan. Flexibility is a key feature of the current system and it ought to be retained.

These basic policy themes underscore our present course: voluntary choices by employers subject to reasonable nondiscrimination rules; protection of core benefits; and flexibility for employers and employees in tailoring retirement and benefit programs to meet individual circumstances.

When tested against these three principles, the APPWP believes that the President's proposals fall far short of the mark and, if enacted without change, will present a serious threat to the continued vitality and diversity of employer-sponsored pension and welfare benefit programs.

We find the President's proposal to repeal section 401(k) especially disturbing. In November 1984, after the Treasury proposed in Treasury I the repeal of 401(k), both employers and employees argued forcefully that these enormously popular and successful plans provided one of the most effective retirement savings vehicles available.

In the face of that evidence, the President's May 1985 proposals reconsidered and rejected the Treasury decision to repeal the 401(k) plan. However, the administration proposal imposed complex rules and unreasonably reduced dollar limits in what appeared to be simply another way of eliminating these valuable retirement programs.

Then, in late August, the administration again suggested the repeal of section 401(k) with no justification other than a bald attempt to raise revenue, presumably to protect tax incentives which hold no benefit for rank and file workers.

This latest change of heart is fundamentally inconsistent with the administration's expressed position that Government-run programs, like Social Security, cannot be the sole source of reliance for these workers. Yet, section 401(k) plans, which have been so successful in encouraging workers to save for their retirement and thus avoid reliance on the Government, are now slated to be eliminated.

Congress should not permit such a flawed proposal to be enacted into law.

I would like to say that at my own company the 401(k) Program, as it has been instituted, has proved to be most popular with employees, who have substantially increased the amounts they were previously setting aside. In addition, the number of employees participating in the program increased.

Mr. Chairman, the APPWP is equally troubled by the Joint Taxation Committee's suggestion that the section 415 limits for defined-benefit and defined-contribution plans be reduced. Aside from the fact that these limits were substantially reduced just 3 years ago, any additional reductions will further erode valuable retirement programs for American workers and threaten the adequate funding of pension plans.

In conclusion, I think we need to recognize that we are moving inexorably toward a system which is increasingly expensive and burdensome for employers to maintain. They may find it less costly in the long run to simply increase current compensation and allow employees to purchase welfare benefits and to save for retirement on their own.

The efficacy of employer-sponsored group benefits has already deteriorated and the system is reeling with repeated changes of the rules in almost every legislative session in recent memory.

The benefit programs of American industry are not endlessly elastic. The changes suggested by this administration need to be carefully reviewed for the hardships they impose on workers and the disincentives they create, rather than for their revenue implications and their administrative ease on the Government.

Ease of enforcement is laudible, but not a goal in and of itself. Short-term revenue enhancement can easily and quickly be eclipsed by larger and more costly burdens on the Government to provide for the old and the ill.

If tunnel vision and shortsightedness have characterized the administration's view of the changes necessary in employee benefits, we urge the Congress not to fall into a similar trap. The need of employees will not diminish in the future.

The only aspect of employee benefits likely to change is the employer's willingness to suffer repeated change and expense to meet these needs.

Thank you.

[The prepared statement of Mr. McCormick follows:]

TESTIMONY OF THE
ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS
BEFORE
THE SUBCOMMITTEE ON LABOR
THE COMMITTEE ON LABOR AND HUMAN RESOURCES
U.S. SENATE

October 1, 1985

Mr. Chairman and Members of the Subcommittee: I am Deane E. McCormick, Jr., President of the Association of Private Pension and Welfare Plans (APPWP).

The APPWP is a nonprofit organization, founded in 1967 with the primary goal of providing and fostering the growth of this country's private employee benefits system. The Association represents over 475 organizations across the United States: both large and small employers who sponsor plans and leading support organizations to private plans including banks, insurance companies, accounting firms, and actuarial and consulting firms. Collectively, APPWP's membership is involved directly with the vast majority of employee benefit plans maintained by the private sector.

I.

Introduction

The APPWP welcomes this opportunity to present its views on those aspects of the President's tax reform program which affect employer sponsored pension and welfare benefit programs. It should be emphasized at the outset that the APPWP does not appear before this Subcommittee simply to represent a narrow constituency. A 1983 study of the Employee Benefit Research Institute reveals that, of the over 88 million nonagricultural employees in the United States, 56% are covered by retirement plans, including more than 37% of employees earning less than $10,000, more than 58% of those earning between $10,000 and $15,000 and almost 79% of those earning between $20,000 and $25,000. The statistics on group health coverage are even more impressive. The Health Insurance Association of America estimates that at the end of 1982, almost 65 million American workers had group health coverage, and including spouses and children, such coverage represents 80% of the under age 65 civilian population. In short, our ultimate "constituency" includes a broad spectrum of America's working men and women.

The APPWP is deeply concerned that the search for revenues in the context of tax reform will, in the coming months, become so intense that these social and economic policy values will not receive the attention they deserve. Indeed, many changes which would not raise revenue but which would adversely affect the delivery of employee benefits may be adopted without an understanding of their effects. We are also deeply concerned that the combination of the hundreds of issues before the tax-writing committees, coupled with the pressures to expedite the legislative process, will necessarily preclude careful pre-enactment analysis of the implications of proposed employee benefits changes. For these reasons, we believe it is especially important for this Committee to make its voice heard in the debate which will determine the retirement security of American workers.

Unless the unfortunate experiences of recent legislative efforts in the pension and welfare benefits area are to be repeated,[1] we urge this Committee to keep in mind three broad policy themes.

II.

Three Basic Principles Should Guide Future Legislative Action Concerning Pension and Welfare Benefit Plans.

A. Voluntary Action by Employers.

We have wisely not required private sector employers to establish and maintain prescribed pension and welfare benefit plans for their employees. Thus, the key to the success of our current broad-based private pension and welfare benefit system rests upon the voluntary decisions of employers, and often employees to establish and maintain such programs.

In recent years, however, we have, perhaps unintentionally, begun to threaten this beneficial but voluntary

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1/ In the 10 years since ERISA was enacted, we have seen five major pieces of tax legislation dealing with pension and welfare benefits. In the last several years, these changes in law have been considered and enacted with such rapidity that their often adverse impact has not been fully examined and they have placed employers and others in a position of being unable to cope with the law. For example, in 1982, Congress enacted special nondiscrimination rules for group term life insurance and a complex set of rules for so-called "top heavy" pension plans. In 1984, the 1982 rules were changed and even more complex rules relating to welfare benefit plans were enacted. Now, in 1985, the President has asked this Committee to repeal many of the changes made in 1982 and 1984 and to adopt new, and often equally complex, rules in their place.

system by legislation which cuts back on benefits, often in the name of deficit reduction, and occurs with such frequency that many employers are beginning to find the revised rules to be so restrictive and so complex that the incentives to establish and maintain employee benefits plans may be insufficient. We need to be realistic. If we are going to continue to rely on voluntary decisions -- as we surely will -- we need to strengthen the incentives and not sacrifice much of what is left of them in the name of revenue neutrality. Among other things, no new benefit limitations should be imposed, the benefit freezes and reductions of 1982 and 1984 should be recognized as inappropriate and should be corrected, and the now almost annual exercise in adding new and complex rules should cease, pending a more deliberate and comprehensive examination of this area.

B. Protection of Core Benefits

The key concerns of employees remain, as always, old age, death, sickness and disability. It is essential that we retain the private sector "security net" that has developed over the past forty years for these hazards and that these core benefits be provided on a collective basis by employers rather than leaving each employee to make his or her own arrangements.

Consider, for example, retirement. The retirement system in this country is based upon the so-called "three-legged stool" of Social Security, private pensions and individual savings. While the Social Security system obviously needs to be maintained and individual savings should be encouraged, the most effective means of assuring an adequate standard of living for the greatest number of older Americans is to continue and strengthen the incentives for employers to provide for their employees' retirement. Employer-sponsored retirement plans are broad-based, providing coverage to vast numbers of employees at all income levels, including those who do not have sufficient current income to cover savings in addition to basic living expenses. In addition, employer-sponsored retirement plans are generally more cost effective than individual programs, through efficiencies of scale and flexibility of investment. Moreover, they provide a chief source of capital necessary for national economic growth.

The arguments are equally compelling with respect to other core benefit programs such as health and life insurance and we should not tamper with them. This does not mean we oppose the new welfare benefit programs -- such as day care and prepaid legal services -- which respond to emerging societal needs and values. These too are important, but the point must be made that we cannot afford to jeopardize the incentives needed to assure maintenance of core benefit programs.

C. Flexibility

The third major policy value -- flexibility -- stems from, and is made necessary by, the diversity of America's employers and their workers. This necessary concept of flexibility has two different policy consequences. First, employers have different needs and abilities. For example, we now permit two basic types of qualified retirement plans: defined benefit plans and defined contribution plans. Both should be preserved for the simple reason that some employers find that defined contribution plans -- with the contribution often expressed as a percentage of profits -- to be the more affordable of the two.

Similarly, employees should also have flexibility to provide for greater retirement benefits -- such as is permitted under so-called section 401(k) plans -- and to select, from among a menu, welfare benefits such as health and life insurance through so-called cafeteria plans. Flexibility is a key feature of the current system and it ought to be retained.

To summarize, three basic policy themes underscore our present policy: voluntary choices by employers subject to reasonable non-discrimination rules, protection of core benefits and flexibility for employers and employees in tailoring retirement and benefit programs to meet individual circumstances.

III.

Specific Comments on the President's Proposals

When tested against the three principles enumerated earlier in this statement, the President's proposals represent an improvement over the Treasury Department proposals released in November, 1984. Nevertheless, we believe the President's proposals fail far short of the mark and, if enacted without change, will present a serious threat to the continued vitality and diversity of employer-sponsored pension and welfare benefit programs.

1. Uniform coverage tests

The proposed uniform coverage tests are an example of a change with meets none of these objectives. This new test, which would be applied to all qualified plans and to all welfare benefits, would require that the percentage of an employer's "prohibited group" members covered under a plan not exceed 125% of the percentage of nonprohibited group members covered under the plan. Thus, the current Code provisions in section 410 for qualified plans would be replaced by a strictly mechanical numerical test that would eliminate the current flexibility in the coverage rules that allows commonly controlled companies with many different plans, covering groups with differing salary structures, lines of business and geographical locations to accommodate these differences in their plans without fear of disqualification. The new rules, which are explained as an attempt to broaden coverage, would go far beyond that goal and require that all such plans be uniform in their benefit levels. Employers would be precluded from fashioning benefit packages in a responsible needs-directed manner, providing certain groups of workers with greater welfare benefits and lesser retirement benefits, while allowing other groups to have higher current compensation and lesser welfare and retirement benefits.

The Administration's approach treats all employees at all wage levels, ages and occupations as fungible, and would discard the flexibility that is a hallmark of our current employee benefits system. Moreover, because of its mechanical nature, this rule would prevent an employer from designing a plan which reasonably and appropriately replaces pre-retirement earnings on a rational basis. Legitimate business transactions would be hampered as the issue of employee benefits becomes a central focus in the decision to buy or sell a business, rather than an administrative detail to be dealt with after the transaction is consummated.

In light of these shortcomings, one would assume that, having considered its effects, the Administration chose to propose this change because of its enormous revenue implication. The opposite is true; this proposal raises virtually no revenue at all. One might also think that the change is supported by clear and convincing evidence that the current rules are not working, and that the new coverage tests will result in far greater coverage at all levels. Again, a false assumption; the new tests may allow the exclusion of middle income employees in far greater numbers than is permitted under current law, thus disadvantaging middle-income employees in the benefits area in the same way that the rest of the Administration proposal serves to do. In addition, if one assumes that the way to avoid the displacement caused by the new coverage tests is to cover all employees in a plan, that assumption would again be proven incorrect. Unless all controlled group plans have the same percentage of prohibited group members, the rules would result in widespread plan disqualification unless all plans in the controlled group were comparable.

The uniform coverage test is similarly unworkable in the welfare plan area. One can quite readily list the arguments opposing the rule based on the comprehensive list of objections raised by the Treasury in 1982 in response to a similar proposal profferred by Congressman Rangel in H.R. 6410. For example, how will one evaluate whether different benefit packages are equal? Moreover, what will the rule do to cafeteria plan arrangements, which have been so successful in allowing employees to choose the benefit package that makes the most sense at a particular age and salary level? What effect will the rule have on cost containment, an area on which Treasury and the Congress have focused so strenuously in the recent past? What about the inflexible and costly administrative burden that this rule will place on benefit plans? Having itself raised these and other issues in 1982, this Administration then concluded that the uniform coverage test was inappropriate and should be stricken from the bill.

We suggest that Treasury's objections just a few short years ago are equally apt today. The new coverage test cannot be justified on revenue grounds; indeed, any revenue it raises would derive from disqualifying plans and eliminating coverage. The new test addresses no demonstated abuse and adds needless confusion, complexity and administrative burden to a benefits system which is still struggling to understand and adapt to the new discrimination rules enacted just last year in the Tax Reform Act. Indeed, new "concentration" rules under the guise of a uniform coverage test will make provision of group life and health coverage by small employers impossible to maintain on a tax-favored basis since the rules would disqualify any plan in which more than 25% of the contributions support a benefit for the twenty most highly compensated employees. Plans covering 50 employees or fewer would almost assuredly fail to meet these new requirements.

We strongly believe that the uniform coverage test is ill-considered, and should be dropped from the current proposals and await an arena where these coverage and discrimination issues can be calmly and rationally addressed on their merits, with an opportunity for the Treasury to put forward evidence that they are indeed a necessary and appropriate change.

2. Section 401(k) plans

In November, 1984, the Treasury proposed in Treasury I the repeal of section 401(k), and thus, the elimination of cash-or-deferred arrangements. Both employers and employees argued forcefully that these enormously popular and successful plans provided one of the most effective retirement savings vehicles available and had gone far in encouraging employees to set aside funds for retirement. In the face of that evidence, the President's May, 1985 proposals reconsidered and rejected the Treasury's decision to repeal section 401(k) plans. However, the Administration's proposal imposed complex rules and unreasonably reduced dollar limits in what appeared to be simply another way of eliminating these valuable retirement programs.

Then, late in August, the Administration again did an about face, suggesting once more the repeal of section 401(k), with no justification other than a bald attempt to raise revenue, presumably to protect tax incentives which hold no benefit for rank and file workers. This latest change of heart is fundamentally inconsistent with the Administration's expressed position that government-run programs, like Social Security, cannot be the sole source of reliance for these workers; yet, section 401(k) plans, which have been so successful in encouraging workers to save for their retirement, and thus avoid reliance on the government, are now slated to be eliminated. Congress should not permit such a flawed policy proposal to be enacted into law.

3. Proposals Relating to Savings Plans

This disincentive to savings is further illustrated by other proposals made in the Administration package, the net effect of which will discourage employee participation in thrift plans. Under the proposal, contributions to all tax-favored plans will be required to remain in the plan until retirement; the penalty for early withdrawal will be an excise tax equal to 20% of the distribution, except in very limited circumstances. Even at retirement, distributions will be treated as a return of taxable earnings first, rather than a return of previously taxed employee contributions. Thus, employees will be reluctant to contribute to a plan in the first instance, when the penalty of removal of funds in times of need is so severe. Even where an employee determines that a distribution is critical, the excise tax and the tax treatment of the distribution combine to powerfully discourage contributions by employees at all. Moreover, the changes in the treatment of employee contributions under Code section 415 make voluntary contributions by middle and upper level employees more difficult as well. While any individual change might be explained or even thinly rationalized by the Administration, the total effect is anti-savings. Far worse, the long-term effect is lesser private resources at retirement for all employees, a result this Committee must act to prevent.

4. Taxation of Health Benefits

We also question the floor on health benefits, which replaces the cap proposed in Treasury I. In the APPWP's view, taxation of the first $10 and $25 of health coverage provided employees is regressive; in addition, it fails to achieve any social policy objectives at all. Indeed, its only virtue seems to be that it raises revenue. We urge the Congress, however, to recognize that health benefits are the most basic and most critical benefit provided to American workers and to appreciate as well the effect that taxation of these benefits would have. One can argue that the amount subject to taxation is relatively small. We would suggest that the numbers proposed by the Administration are deceiving and it is not at all unlikely that, if enacted, this floor tax will be raised over time until employees, particularly at lower income levels, will choose not to be covered by these programs rather than be taxed without an increase in salary to enable them to pay the tax.

IV.

Conclusion

We are moving, inexorably, toward a system which is increasingly expensive and burdensome for employers to maintain. They may find it less costly in the long run to simply increase current compensation and allow employees to purchase welfare benefits and to save for retirement on their own. The efficacy of employer-sponsored group benefits has already deteriorated and the system is reeling with repeated changes of the rules in almost every legislative session in past memory. As employers become unable to provide qualified plans at appropriate levels for their key employees, they will choose to provide these benefits in non-qualified arrangements. Thus, benefits for the rank and file will be reduced, if not eliminated. As we have pointed out before, the benefits programs of American industry are not endlessly elastic; at some point, the burden will primarily shift to the government to ensure that the welfare and retirement needs of American workers will be met. The changes suggested by this Administration need to be carefully reviewed for the hardships they impose on workers, and the disincentives they create, rather than for their revenue implications and their administrative ease on the government. Ease of enforcement is laudable but not a goal in and of itself; short-term revenue enhancement can easily and quickly be eclipsed by larger and more costly burdens on the government to provide for the old and ill. If tunnel vision and short-sightedness have characterized the Administration's view of the changes necessary in employee benefits, we urge the Congress not to fall into a similar trap. The needs of employees will not diminish in the future. The only aspect of employee benefits likely to change is an employer's willingness to suffer repeated change and expense to meet these employee needs.

Senator NICKLES. Mr. McCormick, thank you very much.

You mentioned you have a company in California?

Mr. McCORMICK. Yes, Mr. Chairman.

Senator NICKLES. What type of company is that?

Mr. McCORMICK. Litton Industries has approximately 80,000 employees.

Senator NICKLES. You have a 401(k). Do you also have a defined-benefit plan?

Mr. McCORMICK. Yes, we do. The defined-benefit plan was a contributory plan. Recently we revised that plan to institute a 401(k) plan.

Actually, the two plans work in conjunction. As I mentioned, the participation by the employees in the plan has increased dramatically and the total contribution by the employees has increased, which necessarily means that their benefits at retirement will substantially increase.

Senator NICKLES. Did you have a defined-contribution plan before you had your 401(k)?

Mr. McCORMICK. No, we did not have a defined-contribution plan at that time.

Senator NICKLES. You both have come out against restrictions. Mr. Anderson, you hit it specifically against a provision that was in the proposal that would basically prohibit lump sum.

You mentioned the idea of giving the employees options. Again I go back to my own experience as a trustee of a pension plan.

We would figure the actuarial equivalent and offer that in lump sum, joint and survivor, 10-year certain, lifetime annuity, whatever. We would offer anything that would come out to the actuarial equivalent.

The proposal would basically, as you mentioned, kind of give a Washington, DC, mandated or selected lifetime annuity or survivor's annuity. Do you feel like that would inhibit employees as far as selecting the option that might best suit their needs or desires?

Mr. ANDERSON. Yes, Mr. Chairman, quite clearly it would, if I could speak directly to our experience at Mobil.

We have both a defined-benefit plan and a defined-contribution plan so that for more than 30 years our employees have been building up what we generically call a savings plans, which is a defined-contribution plan. It is typical, at retirement, for employees to take a lump-sum distribution from the savings plan and use that to make certain asset redeployment decisions to provide for their further retirement security.

The provision in the tax bill would simply impose a substantial tax burden on anyone who chose to withdraw their capital stock from the savings plan. For example, it would be typical for a retiree in our company to choose to pay off their mortgage so that they would reduce their fixed living expenses or perhaps to use the funds to buy into a business where they might add some additional income to their retirement income, or to make some other capital redeployment which is directly related to their retirement security.

It would seem to us that the policy that we are looking at in the tax bill is one that says that the only retirement purpose that will be favored under the code is the provision of retirement income. It strikes us that for the better part of 20 years we have spoken in terms of retirement security, generally, recognizing that there is both an income and a capital component to that.

Senator NICKLES. But is the most damaging thing the elimination of the 10-year forward averaging?

Mr. ANDERSON. It's the elimination of 10-year forward averaging. It's curious phenomenon from a tax policy standpoint.

The greatest benefit of 10-year forward averaging is enjoyed by lower income people.

Senator NICKLES. Could you explain that?

Mr. ANDERSON. Well, the principal effect of 10-year forward averaging is to allow you to spread part of your income in a lower bracket. Now, to the extent that the gross distribution to you has the effect that if you divide it by 10, that leaves you in a 50-percent bracket under today's rules. Then you get a very diminished benefit of averaging.

However, the gross amount to be distributed to you, if you divide that by 10 and, let's say, it leaves you in a 20-percent bracket, you then enjoy having the total distribution taxed in the lower brackets.

I'm not suggesting that it is not an advantage to both higher income and lower income people, or people with a larger versus a smaller distribution; but the biggest advantage or the relative advantage to a lower income person is greater than it would be to a higher income person.

Senator NICKLES. You mention you have had these plans for years; and that these plans were set up, whether they be defined benefit or defined contribution, with lump sum as an option. As you mentioned, under defined-contribution plans many times lump sum is the primary option.

Those were set up with everyone being well aware of the fact that there was a 10-year forward averaging and the fact that, yes, this is retirement income and you will no longer still be fully employed; and, therefore, your income would be substantially less and your tax brackets would be substantially lower.

If we came in and changed that, don't you feel like that would be somewhat breaking the implied contract between the employer and the employee as far as maintenance of their future security?

Mr. ANDERSON. Well, quite clearly, Mr. Chairman, if the company were to propose on its own initiative to amend the plan and eliminate that option, I think that there would be serious questions as to whether or not we could do that.

But, quite clearly, if Congress wishes, in its judgment, to withdraw the advantages of 10-year forward averaging from these participants and these employees, I assume that you all have the power to do that.

I think you make a very good point. You are dealing with accumulations of capital that belong to individuals and the money was, in fact, put aside in these trust accounts by them over a long period of time in reliance on a number of assumptions, one of which is that they would get something akin to 10-year forward averaging at retirement.

I'm a bit loath to argue that point, though, with you directly. I think that we would prefer to suggest to you that 10-year forward averaging, in and of itself, should be retained, both retroactively as well as with respect to prospective accumulations.

I happen to believe that individuals should be given the opportunity to elect the lump-sum distribution, if they conclude that it's appropriate in their circumstances. I think to substitute, directly or indirectly, governmental judgment that lump sum is inappropriate perhaps intrudes too far into what should be private economic decisions.

Senator NICKLES. I would agree with that.

Also, in the proposal was something along the lines, I believe, that currently if you are receiving your contributions on an annuity basis or whatever, the way we have received it in the past you would receive your dollars back first, which were aftertax dollars, and therefore that would not be taxable until after you have received back your actual contributions; then income above that amount would be taxable.

Correct me if I'm wrong, but I believe the proposal would change that.

Mr. ANDERSON. That's correct. I'm not as familiar with that particular proposal as I might be with some others because we don't have a contributory plan; but my understanding of the proposal is that they would change the present treatment under the Internal Revenue Code so that, in a contributory annuity plan whereas, today, you recoup your own contributions as the first dollars that you receive—and the effect of that, I believe, is that the first period of your payments are basically tax free; it's only after you have received back the amount that you have contributed that the balance is then considered taxable income—that would be changed.

I think the same objection might be mounted to that as you would mount to the others with respect to the reliance that people have placed on those provisions over the past years.

Senator NICKLES. Wouldn't you find that grossly unfair if individuals contributed aftertax dollars into a retirement plan and then, when they begin receiving retirement benefits out, not to receive those aftertax dollars back first?

If we change that, don't you find that that would be grossly unfair? In some cases, if you are talking about a straight-life annuity, you could easily find a situation where an individual would pass away and, therefore, not even receive their own tax-free dollars back. They would be paying taxes back on, actually, the initial contributions.

Mr. MCCORMICK. I think it would be very upsetting to many of our employees. As I mentioned, our basic defined-benefit plan was employee contributory.

When the employee retires, it is typical for him to take back his own contributions first, and perhaps buy an annuity with it. If he did, he can sometimes end up getting more in retirement total than if he had left his money in the plan.

But I think an employee would be very upset if he was taxed on that transition.

Senator NICKLES. Both of you mentioned opposition to the termination of 401(k) and both of you mentioned opposition to, actually I guess, the interim 401(k) plan—and that was one that had some limitations and restrictions.

The current limitations are, what, $30,000 or 25 percent of income, whichever is less in the 401(k)'s?

Mr. McCormick. Essentially, yes. I believe so.

Senator Nickles. Would you favor as a compromise the possibility, that some people have bandied about, of some limitation? The figure $8,000 has been thrown out because that was what was in Treasury II, I believe.

Are you opposed to any limitation on 401(k)'s?

Mr. McCormick. I think the only limitations that should exist are the same limitations that would exist under the 415 limit: in other words, the $30,000. The 401(k), in my own concept and as utilized at my company, is simply a way for providing retirement income for an employee.

It facilitates the employer and the employee to work together to provide that retirement income. I see no purpose of truncating a particular method to where it can only achieve a partial effectiveness.

Senator Nickles. Mr. Anderson, do you want to comment?

Mr. Anderson. Mr. Chairman, I would like to suggest to you that it has become popular to characterize 401(k)'s as sort of being out of control. There are a broad array of very technical difficult limitations that are imposed on contributions and deferrals into the 401(k) Program.

It is true that the deferrals into 401(k) must fall within the aggregate $30,000 limit imposed by section 415. It is also true that to the extent that other contributions by the employer are counted as part of that $30,000, then the amount that the person may defer in the 401(k) is further reduced.

In addition to that, with respect to the highly compensated people—the top one-third in the pay spectrum in any company that has a 401(k)—their deferrals are further limited in relation to the percentage that is actually being deferred by the lower paid group.

For example, in our company, at Mobil, the deferrals for the higher paid one-third must average no more than, I believe, 6 or 7 percent and the deferrals for the lower paid two-thirds are a percentage point or so below that.

So that we have some effective brakes on the amount that can be contributed now which bring the actual deferral numbers, in the aggregate or on the average, well below what you might expect to encounter if you had focused on this $30,000 number.

The second point I would like to make to you is that you might consider the implications for a number of people who are particularly advantages by the 401(k). An example: the person nearing retirement.

One of the beauties of 401(k) is that the person who is within 5 years of retiring who has his or her other family obligations discharged—the kids are out of college, the mortgage is mostly paid off, they are not worried about buying a new car—who has disposable income and who is confronting retirement income needs has the ability, with the 401(k), to on their own initiative make a decision to save more money and put that money away.

If we have an artificial cap, whether that cap is $5,000 or $8,000—pick a number—you will impinge on their ability to make those kinds of decisions. Furthermore, as you well know we have had lots of discussion in the last 10 years or so about the increasing mobility in the work force.

The 401(k) is an opportunity for someone, perhaps who has been mobile, when they reach a time when they need to try to make up for the fact that they have, perhaps, not vested somewhere else, they can make individual decisions and take an initiative on their own to save more than the average person may save.

Senator NICKLES. Let me ask a couple of quick questions. I need to move on to the next panel, but these are important questions.

The 401(k)'s are tax-deferred defined-contribution plans. You have thousands of defined-contribution plans that are out there right now that are aftertax.

I would imagine there is just as many thousands that are in the process of converting those to 401(k)'s primarily for the tax advantage: set up defined-contribution plans, recognizing the positive impact on employees of making that tax-deferred versus aftertax.

I think Treasury is probably correct as far as the explosion of 401(k) plans. I think there has been a lack of awareness—particularly, as Mr. Swain said among a lot of small businesses, about the availability of 401(k) plans. However smaller plans are becoming more aware of them and their great tax advantages.

There seems to be some inequity in that the majority of older defined contribution plans are using aftertax dollars. Yet here you are coming up with another form of retirement income which is sometimes a supplement, and one is aftertax and one is tax-deferred when comparing defined-benefit plans and the 401(k)'s.

I personally see that and I also see the advantages for the employee. I see a great movement that, if it is not changed—and I am not saying it should or should not be—away from defined-benefit plans because of the tax advantages on 401(k)'s and away from defined-contribution plans into 401(k)'s if it is not changed; or, at least, some would argue that.

What would your response be?

Mr. MCCORMICK. Well, from our own viewpoint, I think one part of the answer is the popularity of the 401(k)'s. What we are after is to provide benefits for the employee in retirement.

I believe it has been demonstrated at our particular company that the 401(k) plan is highly acceptable to an employee, he participates in it. I indicated we have more dollars coming in by the employee than we had before and we have more employees being covered.

So you have more employees, you have more dollars. So you have expanded the effectiveness——

Senator NICKLES. Mr. McCormick, did yours replace a defined-contribution plan?

Mr. MCCORMICK. Well, it does not replace a defined-contribution plan, no. We previously had a defined-benefit plan, which is now integrated with the 401(k) plan.

We studied the program long and hard trying to figure out what sort of program to put in. We decided upon that program and one of the little technical recommendations by the administration would be to prevent the combination of the two-type programs that Litton has put in.

As far as I know, there are not many other companies that have gone the way we have gone, and I can't think of any good to be accomplished by preventing the combination that we have effected.

Senator NICKLES. Mr. Anderson, do you want to answer that question?

Mr. ANDERSON. I would like to suggest to you, Mr. Chairman, that, again, I think I have heard as much talk as anybody has about 401(k) displacing existing programs. We have not seen that.

The pattern of experience that we have had with our companies, or the companies have had, is that almost all of them will sponsor a defined-benefit plan. In addition to that, they have a history of sponsoring an employer-financed defined-contribution plan.

They will then adopt a 401(k) as part of that existing defined-contribution plan. The purpose in those companies is simply to give the employees an opportunity to make some personal decisions with regard to what level of savings they need to anticipate their own retirement.

Let me suggest to you that one alternative the companies all have is to increase the amount that the employer is putting into the existing defined-contribution plan. That tends to be a kind of a gross way to approach the issue of providing additional retirement savings because it increases the contribution rate for both those employees who want it and need it, as well as increasing the contribution rate for those who, perhaps, are not as concerned about it.

What 401(k) allows us to do from a policy standpoint is leave those decisions up to the individuals. Those who think that they have the need will go ahead and make the contributions. Those who have another need for the money will spend it on some other purpose.

Senator NICKLES. Gentlemen, I appreciate your interest very much. There may be some additional questions submitted for the panel.

Thank you very much.

Mr. ANDERSON. Thank you, Mr. Chairman.

Mr. MCCORMICK. Thank you.

Senator NICKLES. On our next panel, we have Barbara Nahra, benefits counsel, TRW, Inc., in Cleveland, OH, representing the National Association of Manufacturers, and also Donald Alexander, counsel, representing the Chamber of Commerce of the United States.

STATEMENTS OF BARBARA H. NAHRA, BENEFITS COUNSEL, TRW INC., REPRESENTING THE NATIONAL ASSOCIATION OF MANUFACTURERS, ACCOMPANIED BY SHARON F. CANNER, DIRECTOR, OF EMPLOYEE BENEFITS; AND DONALD C. ALEXANDER, COUNSEL, REPRESENTING THE U.S. CHAMBER OF COMMERCE, ACCOMPANIED BY FREDERICK J. KREBS, DIRECTOR, EMPLOYEE RELATIONS

Ms. NAHRA. Mr. Chairman, members of the Labor Subcommittee, I am Barbara Nahra, benefits counsel for TRW, Inc., headquartered in Cleveland, OH. I am here today representing the National Association of Manufacturers, a trade association of 13,000 member companies employing 85 percent of the Nation's manufacturing employees.

With me is Sharon Canner, the NAM's director of employee benefits.

I am going to deviate somewhat from my written statement, which I ask to be entered in the record.

Senator NICKLES. Certainly.

Ms. NAHRA. While TRW is generally supportive of the President's tax proposals, the NAM and TRW are concerned with many of the employee benefit provisions. It is appropriate that employee benefits be considered separate and apart from the broader tax questions and we appreciate the opportunity to appear before your subcommittee.

Although we support the concept of nondiscriminatory plans in exchange for advantageous tax treatment, we believe the proposed changes would be cumbersome, expensive, and totally impractical to administer—all without raising any revenue.

Differently designed plans maintained by diversified corporations are not intended to discriminate, but to reflect different competitive needs in varying lines of business and the varied lifestyles and needs of a geographically diverse workforce.

Regarding the distribution rules, I would like to stress the disruption to our employees that would be caused by the proposed changes to tightly restrict the distribution of benefits from qualified plans prior to 59½. Many of our hourly workers plan to retire after 30 years of service. We have many employees who would like to retire early for many reasons. For others, there may be no choice—their jobs have gone elsewhere.

We question the apparent view of the administration that the only socially desirable purpose for qualified plans is for retirement use. We believe that savings by our country's employees, which is far below the rate in other developed countries, contributes to capital formation.

This leads me to the proposed limitations on section 401(k) plans. These plans have provided a savings vehicle to rank and file employees in unprecedented numbers, and they have been established by small employers who previously had no benefit plans for their employees.

There are a number of advantages to these plans in contrast to individual retirement accounts: employer-matching contributions, employer-provided plan management, the convenience and the forced regularity of the payroll deduction vehicle for making contributions, and the perception—crucial to employees—that their savings are accessible should the need arise.

To illustrate, I would like to focus briefly on the TRW Stock Savings Plan which was amended January 1, 1984 to provide the pretax contributions. Prior to the change, the average participation rate was 41 percent; the change increased 1984 participation to approximately 70 percent; and, at the end of 1984, participation had reached nearly 75 percent.

To give some idea of participation by the lower paid based on data as of the end of 1984, we had 59 percent of those in the $10,000 to $15,000 salary range participating, 69 percent of those earning $15,000 to $20,000, 73 percent earning $20,000 to $25,000;

and we had 69 percent of our nonexempt employees participating in the plan.

Regarding plan distributions, while dollar contributions to the plan nearly doubled in 1984, total distributions from the plan significantly declined due to the tight limits on withdrawals of pretax contributions. In 1982 and 1983, the aggregate dollar contributions going into the plan were offset by an approximately equal dollar value in distributions from the plan. In contrast, total payouts and withdrawals in 1984 were only 33 percent of the dollar value of plan contributions.

This illustrates several desirable characteristics of section 401(k) plans in contrast to aftertax plans or IRA's. If the money can be withdrawn without restrictions, a higher percentage of participants will elect a distribution whether or not other funds might be available. However, the availability of hardship withdrawals is necessary to incentivize participation by employees with little discretionary income.

Because the hardship tests are difficult to meet and any loans will be returned to the plan, a far greater number of dollars is being put aside for retirement for a greatly increased participant base. That, to the members of the NAM, is a successful retirement income policy. The needs of individual workers coupled with the need to encourage capital formation are strong incentives to expand section 401(k) plans, not to severely limit or abolish them.

In conclusion, we would like to offer some general comments on employee-benefits legislation. The employer's ability to make long-term planning decisions with some assurance that the rules will not be abruptly changed is important to the success of these programs.

Since 1980, Congress has passed four major bills making significant changes to employee-benefit programs. Consistency in employee-benefits policy is essential if companies are to be encouraged to provide high caliber programs for American workers. The current employee-benefits system is a great success story. Let's not destroy it.

Thank you.

[The prepared statement of Ms. Nahra follows:]

Testimony of
Barbara H. Nahra
Counsel, Benefits
TRW Inc.
on Behalf of

the National Association of Manufacturers

Before the
Labor Subcommittee
Labor and Human Resources Committee
U.S. Senate
on Implications of the President's Tax Proposal
on Employee Benefits and Retirement Savings

October 1, 1985

Mr. Chairman and members of the Senate Labor Subcommittee, I am Barbara H. Nahra, Counsel, Benefits, TRW Inc., Cleveland, Ohio. I am appearing today in my capacity as a member of the National Association of Manufacturers' Employee Benefits Committee. Accompanying me is Sharon Canner, NAM's Director of Employee Benefits. The NAM is an organization of over 13,000 corporations of every size and industrial classification located in every state. Members range in size from the very large to over 9,000 smaller manufacturing firms, each with an employee base of less than 500. Our members employ 85 percent of the workers in manufacturing employment and produce over 80 percent of the nation's manufactured goods. NAM also has an affiliation with 158,000 businesses through its Association's Council and the National Industrial Council.

Mr. Chairman and members of the Senate Labor Subcommittee, we are pleased you are holding this hearing on employee benefits and giving this public policy area your time and attention. It is altogether appropriate that employee benefits be considered separate and apart from the broader tax questions and we appreciate the opportunity to participate in this important discussion before your Subcommittee. The following statement will provide an assessment of private employer benefits, comment on specific portions of the Administration's Tax Proposal, and offer some concluding remarks concerning stability in the administration and communication of employee benefit plans.

Employer-Provided Benefits: A Great Success Story

The number of workers covered by employee benefits is impressive. Of approximately 88 million persons engaged in non-agricultural occupations in 1983, 82 million had health insurance, and when family members are added, 162 million persons actually enjoy health insurance protection provided through employer plans. Coverage in other areas includes life insurance (72 million); disability insurance (51 million); dependent care (2 million); educational assistance (5 million); cafeteria or Section 125 plans (5 million); and pension plans (56 million).

By the end of 1984, nearly 20 million persons were participating in 401(k) plans, according to the Employers Council on Flexible Compensation. Small businesses have been quick to adopt 401(k)s. Nearly a half million small businesses now offer these plans to about 4.5 million employees. Of these businesses, 37 percent utilize 401(k)s as the only retirement vehicle.

Private sector benefits provide American workers with a high degree of economic security assuring necessary medical care, income maintenance during short and long term disability, and adequate retirement income. In addition, individuals are encouraged to save for supplemental retirement income, and for other socially desirable purposes such as home purchases, educational expenses, and unforseen emergencies.

Beginning as early as 1921, the federal government, through the tax code, has encouraged employers to offer such benefits to workers. Over the years, an efficient and flexible system has evolved.

Because of this policy, the federal government, unlike its European counterparts, has not become the major provider of benefits. For example, the private sector has been encouraged, through tax incentives, to be the key sponsor of health protection which today costs approximately $100 billion a year. Less than one-third of that amount "costs" the government in the sense of foregone taxes. Should the government provide this protection, the replacement cost would be at least the full $100 billion.

In the retirement area, the three-legged stool of savings, employer-provided pensions, and Social Security form an important partnership in assuring income security. If incentives for saving to supplement retirement income are dramatically altered or other amendments are made to qualified plan rules, pressure to increase

Social Security benefits can reasonably be expected. Recently, following statutory changes, Social Security was forecasted to be on firm financial footing. However, policymakers assumed the private retirement system would furnish individuals with a significant level of retirement income.

Of an employee's total compensation package, which generally includes salary, paid absenses from work, vacations, employer contributions to government programs, and employer-sponsored health, life, and pension programs, only about 10 percent is accorded preferential tax treatment. Taxes are deferred, meaning they will be paid at a later date, on items such as retirement, disability insurance, and savings plans. This tax policy has encouraged savings and protected retirement income.

The current employee benefits system is a great success story, substantially because of a favorable tax policy with the employer, the employee, and the federal government working together. Let's not destroy it.

The Administration's Tax Proposal

The Administration's proposal, released on May 28, would make sweeping changes to employer-sponsored plans including changes in nondiscrimination rules, distribution rules, 401(k) and IRA contributions, excess plan assets, and the tax exclusion for health insurance. Our comments below address each of these individually.

- Uniform Nondiscrimination Rules for Retirement and Welfare Plans. To achieve plan qualification status, a new coverage test would have to be met. Under the new test, a benefit plan would be considered nondiscriminatory if the percentage of the prohibited group (those highly compensated and select others) benefiting by the plan does not exceed 125 percent of the percentage of the nonprohibited group. Exceptions to the rule include collective bargaining agreements, part time workers and those with less than one year of service. This new test would raise little revenue. It would, however, raise labor and administrative costs and put nonunion companies at a disadvantage. The proposed nondiscrimination rules would require company-wide plans, a matter of great concern to conglomerates in multiple lines of business located in various parts of the country.

  Mobil Corporation, for example, is the holding company for three distinct lines of business: Mobil Oil, Montgomery Ward, and the Container Corporation of America, each of which maintains separate retirement and welfare plans. Although the Mobil Oil plan covers virtually 100 percent of prohibited group members and 100 percent not in the group, the plans would fail the new test, because the test must encompass all employees of Mobil Corporation, (the holding company) for diverse lines of business such as Mobil Oil and Montgomery Ward. (Below we provide the formula supporting this conclusion.)

$$\frac{\text{6,400 PGM Benefit by Mobil Oil Plan}}{\text{8,100 PGM Total Mobil Corp.}} = .79$$

$$\frac{\text{24,000 non PGM Benefit by Mobil Oil Plan}}{\text{113,000 PGM Total Mobil Corp.}} = .21$$

79% = 372% of 21%

Uniform plans for Mobil, TRW and other similarly structured companies would be cumbersome, expensive, and totally impractical to administer. Corporations have provided different benefit plans to accommodate varied lifestyles and needs of workers. These considerations are important in attracting a competitive workforce. Maintaining this flexibility is essential for the continued vitality of our nation's industry.

Certainly the nondiscrimination rules are a complex issue requiring careful study. We would be glad to work with you in resolving the technical details of any changes to such rules.

- Distributions from 401(k) Plans and Other Qualified Plans. The Administration's tax plan proposes many changes affecting distributions from qualified plans, such as IRAs, sheltered annuities and 401(k) plans. A more targeted attack was made on 401(k) plans in particular when Treasury Secretary Baker, on September 4, wrote House Ways and Means Committee Chairman

Rostenkowski recommending the total elimination of these salary reduction plans. It is clear that the intent of the proposed rules is to restrict distributions for retirement income to a stream of payments versus lump sums. Removal of hardship distributions and income averaging, as well as the imposition of various excise taxes, are all part of this.

The Treasury seems to take the view that the only socially desirable purpose for the tax-favored treatment of qualified plans is for retirement use. Saving, also a socially desirable purpose, is vitally important in order to encourage long term investment in our nation's future. We observe, however, that in the United States, savings rates are far below that of other developed countries. Thus, we believe that it is socially desirable to encourage savings through vehicles such as tax-favored plans, thereby contributing to capital formation.

Supplemental savings plans may at times have a lessor priority than savings for catastrophic medical expenses, home purchases, periods of unemployment or college tuition, but hardship withdrawals should not be so severly restricted as to totally discourage individuals from saving altogether. In Canada, where the laws on withdrawals from similar savings plans are very restrictive, the participation rates are lower. Southland Corporation, which operates convenience stores in both the U.S. and Canada, has an 84 percent participation rate for its 401(k) plan in the U.S., versus a 50 percent rate in Canada.

- Contributions to 401(k) and IRA Plans. The proposal, as released in May 1985, would limit an employee's contributions to a 401(k) plan to $8,000 offset by any contributions to an IRA. As mentioned earlier, the Administration now proposes that 401(k) plans be eliminated. Since their creation in 1980, 401(k) plans have played an integral role in encouraging retirement savings, by providing for an employer match and administration of the plan. A 1985 survey by Hewitt and Associates reports that participation among the lower paid two-thirds jumped to 64 percent when companies provided a dollar-for-dollar participation match as compared to a 41 percent participation rate when plans had no matching contributions. Those earning between $5,000 and $10,000 were three times more likely to participate in a 401(k) plan than in an Individual Retirement Account. Middle income workers earning up to $29,999 preferred 401(k) plans over IRAs two to one.

In the long term, it is important to view savings plans outside of their tax context. Thus, it seems to us that the needs of the individual worker coupled with the need to encourage capital formation for long term economic growth are important reasons to encourage the use of salary reduction plans, such as 401(k) plans, rather than to severely limit their operation.

- Excess Plan Assets. A 10 percent excise tax would be placed on the amount of assets reverting to an employer upon termination of a defined benefit plan. This tax, in effect, would be a penalty that employers would have to pay as a result of the prudent management of pension plan assets. The tax would result in employers redirecting their investments to yield only that amount necessary to adequately fund plans and readjusting amortization schedules. Not wishing to overfund, the net result might well be a tendency to underfund plans. So, this tax would make little sense in terms of assuring that pension benefits are adequately protected. Indeed it would thwart the most basic goals of our nation's retirement income system. Further, such excise taxes would encourage defined contribution plans at the expense of defined benefit plans.

- Health Insurance Tax. The proposal would tax employees on the first $10 (for single coverage, $25 for family coverage) of the monthly premium paid by the employer. Workers might be encouraged to bargain for richer benefits without incurring greater tax liabilities. The proposal is regressive affecting those least able to afford it while at the same time doing nothing to encourage health cost containment. It is easy to see that the dollar amount would probably be raised in future years depending on the government's need for additional revenue. The floor tax is a revenue-raiser with no apparent social policy or tax reform objective.

A second approach advocated by some is to tax health benefits above a certain amount. This so-called "tax cap" also has serious flaws. A tax on benefits above a ceiling amount would penalize certain high risk groups such as the elderly and workers in hazardous occupations and it would be geographically inequitable as well.

Both the tax floor and tax cap are ill-advised proposals. Their impact would disrupt employee health benefit plans, which now cover some 96 percent of workers in large and medium-sized firms. Group health insurance has been instrumental in protecting workers and their families against financial ruin due to medical expenses. Moreover, the security of health insurance has made a significant contribution to worker productivity through enhanced physical and emotional well-being.

Conclusion

In conclusion we would like to offer some general comments on employee benefits legislation and regulation. The employer's ability to make long term planning decisions with some assurance that the rules will not be abruptly changed is important to the success of these programs. Since 1980, the Congress has passed three major tax bills making significant changes to employee benefit programs with implementing regulations yet to be issued in many instances. The tax proposals announced in May pose yet another set of potential changes. Consistency in employee benefits policy is essential if companies are to be encouraged to provide high caliber programs for American workers.

Aside from the benefit rule changes discussed here, there remain other major issues before the Congress, including vesting, integration, and portability (VIP), and an increase in the Pension Benefit Guaranty Corporation (PBGC) premium. Ample time is needed to tackle these areas before opening up an additional new legislative arena. The uniform nondiscrimination rules, for example, would require employers to test and, in many instances, restructure existing benefit plans for their workforces at considerable expense. It would seem prudent to impose a moratorium on employee benefits legislation to permit the issuing of long overdue regulations which seek to explain past tax legislation affecting benefits.

Overall, the goals of tax reform as articulated by the Administration's proposal are to simplify and grant equity to the greater majority and yet remain revenue neutral. In the employee benefit area the proposed changes would add complexity and expense. Any revenue gain attributable to the health floor tax and the elimination of 401(k) plans, would be insignificant compared to the long term effects of such proposals. In view of this, we urge you to consider carefully how such changes would seriously damage a system that now works well in providing for the economic security needs of American workers.

SUMMARY

This nation's private employee benefits system is a huge success story: 56 million workers are covered by pension plans; 96 percent of workers in medium-to-large-sized firms have health insurance protection; and added to this is broad coverage for life insurance, disability and other employee benefits. Through the tax code, the federal government has encouraged employers to provide benefits and at the same time motivated workers themselves to save for retirement through mechanisms such as 401(k) plans. In the name of tax reform the Administration has proposed to adversely alter a highly efficient and flexible system which has been successful in meeting the retirement and economic security needs of Americans for nearly sixty years. Certainly we recognize the problem of budget deficits and the need to reform the tax code in certain areas. Within this context, however, employee benefits deserves consideration separate and apart from the broader tax issues.

The Administration's tax proposals would affect private sector benefits in the following ways: (1) new nondiscrimination rules for retirement and welfare plans would disqualify many existing plans, and mandate uniform company-wide plans restraining a corporation's competitiveness and raising labor costs; (2) distributions from qualified plans would be severely limited thereby discouraging individuals from saving; (3) contributions to 401(k)s would be eliminated, again, discouraging savings; (4) an excise tax placed on assets reverting to an employer upon termination of a defined benefit plan would prompt employers to redirect investments and possibly underfund plans; and (5) a tax on the first $10 of health insurance for a single plan ($25 for a family plan) would thwart health care cost containment efforts now underway.

Employee benefits are being asked for the fourth time since 1980 to absorb major legislative changes while regulations for earlier tax laws have yet to be issued. In view of this, we urge you to consider carefully how such changes would seriously damage a system that now works well in providing for the retirement and economic security needs of American workers. Let's not destroy a great success story.

Senator NICKLES. Thank you very much.

Mr. Alexander.

Mr. ALEXANDER. Thank you, Mr. Chairman. My name is Donald Alexander. I would like to have my statement entered into the record. I don't want to read any of it.

Senator NICKLES. Certainly.

Mr. ALEXANDER. With me is Frederick J. Krebs, director of employee benefits for the U.S. Chamber of Commerce. The U.S. Chamber of Commerce, Mr. Chairman, is composed, by 92 percent of its members, of businesses who have less than 100 employees.

So we are a small business organization and can speak to the problems that you discussed this morning and that have been discussed by previous witnesses.

I agree completely with the NAM's view. Let's have some certainty and some consistency in an area that badly needs it. Let's not dash people's expectations of the tax treatment of their retirement funds.

Let's not change the rules in the fourth quarter on how the game has to be played. Let's leave the system alone unless there's a real need for change.

Now, the Treasury II proposes vast changes in employee benefits and in our Nation's tax treatment of retirement plans. On top of Treasury II, we now have 49 pages—this is just the outline, Mr. Chairman—of Joint Committee options, some of which agree with Treasury II, some of them seem to agree with what was in Treasury I, and some of them disagree with everything, as far as I can see.

We have a vast period of uncertainty. We don't know what the rules are. If a small business was thinking about trying to adopt a retirement plan because its affairs were going pretty well and at last it could afford it, it would not know what to adopt or how to go about it, or whether it would have to change the plan right after it spent the heavy fees that are involved in complying with whatever the law may be now when you don't know what the law is going to be in the future.

Section 401(k) has been thoroughly discussed already this morning. I don't need to develop that in depth.

We now find in the joint committee options that we would go back to sort of a modified Treasury II, only worse, with a $5,000 limit substituted for an $8,000 limit and all sorts of mysterious and arbitrary restrictions put on what is a good vehicle for the delivery of a retirement income—a substitute for earned income—to people who badly need it giving some weight to individual choice.

The system works, as Mr. Anderson pointed out, and it ought to be permitted to continue to work.

You discussed this morning, Mr. Chairman, one of the changes which is proposed in Treasury II and also seems to survive in the staff options that are under consideration over in the other body, and that is the reversal of the rules on recovery of employee contributions.

The ordering rules are turned completely around. Instead of the distributions being, first, those considered being made by the employee, they are first considered to be those made by the employer with precisely the consequences that you reviewed.

Senator Simon talked about the uncertainty created by the present confusion as to what, if any, changes will be made. To the extent that that uncertainty can be resolved promptly, it certainly should be.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Alexander follows:]

STATEMENT
on
EMPLOYEE BENEFITS TAXATION
before the
LABOR SUBCOMMITTEE
of the
SENATE LABOR AND HUMAN RESOURCES COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Donald C. Alexander
October 1, 1985

Mr. Chairman and members of the Subcommittee, my name is Donald C. Alexander, and I am a partner in the law firm of Cadwalader, Wickersham & Taft. I am testifying on behalf of the U.S. Chamber of Commerce, the world's largest federation of business companies, chambers of commerce and trade and professional associations. I serve on the Chamber's Board of Directors and on four of its policymaking committees: Labor and Employee Benefits; Taxation; Government and Regulatory Affairs; and the Council of Small Business. From 1973 to 1977 I was Commissioner of Internal Revenue. Accompanying me today is Frederick J. Krebs, Director of Employee Relations for the Chamber.

On behalf of the Chamber of Commerce, I am pleased to appear today to testify on the employee benefits provisions of the President's Tax Proposals to the Congress for Fairness, Growth and Simplicity.

The Chamber applauds the President and his Administration for developing a comprehensive tax reform proposal. In June the Chamber testified before the House Ways and Means Committee in support of tax reform which would continue to increase economic growth by stimulating capital formation, technological advancement, international competitiveness, and job creation.

We also commend you, Mr. Chairman, for holding this important hearing. In our statements in recent weeks filed with both the Senate Finance and House Ways and Means Committees, the Chamber urged those tax committees to recognize the concerns of relevant Congressional committees that have substantive jurisdiction over pension and employee benefit issues. Accordingly, this hearing could not be more timely, given the serious threat to the private sector employee benefits system posed by the various taxation proposals.

I. THE SUCCESS OF THE PRIVATE-SECTOR EMPLOYEE BENEFITS SYSTEM

The U.S. Chamber supports the development and maintenance of a strong, voluntary, nondiscriminatory, private sector employee benefits system, which can vary in accordance with the needs of employers and employees. Accordingly, proposals to subject employee benefits to taxation and further regulation or to use the tax code to mandate health benefit plan design concern us.

The Reagan Administration has been committed to less government intrusion into business. Its goals of privatization and deregulation of certain government services are shared and supported by the Chamber. The proposed new rules contained in the Tax Proposals regarding distribution and nondiscrimination requirements for employee benefit plans are inconsistent with these goals.

Incentives for business to offer health and insurance benefits to employees reduce the utilization of and pressure on government-provided services. Reduced regulation and taxation of employee benefit plans would reduce business costs and allow greater flexibility in choice of benefits for workers. The Employee Benefit Research Institute (EBRI) estimates that the $100 billion of health coverage provided by employers to some 82 million workers costs the government less than one-third of that amount in foregone taxes. The replacement cost of similar health protection provided directly by the government would be the full $100 billion.

Employer-provided benefits thus fulfill a number of worthy objectives, including the maintenance of a less extensive and less costly Social Security system, avoidance of the burdens of a broadly based national health system, encouragement of a sense of affiliation with an employer leading to increased employee productivity, and provision of an important source of savings and investment and substantial risk protection to American workers and their families against the vicissitudes of injury, illness, unemployment and death of a wage earner.

Under the proposed changes, many currently tax-qualified retirement and health plans will not maintain tax-qualified status, and numerous businesses -- especially small businesses -- will be discouraged from establishing health or retirement savings plans. As a result, the Social Security system and other government programs may be called upon to provide a greater proportion of health protection and retirement security.

In short, employer-provided benefits are efficiently and effectively providing necessary protection for individuals that would otherwise have to be provided by the government -- the very same individuals, taxpayers, who are intended to be helped by tax reform. Imposing new rules and subjecting benefits, such as workers' compensation, health benefits and the untaxed portion of unemployment insurance, to income taxes and payroll taxes for both employees and employers would be contrary to the philosophical underpinnings of the tax reform proposal: simplicity, fairness and economic growth.

II. COMMON MISCONCEPTIONS ABOUT EMPLOYEE BENEFITS

Taxing employee benefits frequently is justified with the assertion that they are only "fringe" benefits for the privileged few. Nothing could be further from the truth. Private employee benefit plans provide benefits to 150 million employees and dependents. Over one million employers are providing retirement and welfare plan benefits. EBRI has documented that almost 95% of all full-time, nonagricultural employees in medium- to large-size firms are provided life, health and disability insurance and that 75% of these employees participate in retirement benefit plans. However, among smaller companies, retirement coverage is less extensive. Tax disincentives for providing coverage, therefore, should be avoided.

Equally important, these benefits are available to a broad range of the work force and are not limited just to the highly paid. Over three-fourths of the employees participating in private pension plans earn less than $25,000. Among employees with vested pension rights, 70% earn less than $25,000; and of employees with health insurance, 80% earn less than $25,000.

Of course, the proposal to tax fully unemployment insurance would affect adversely the families of Americans without jobs, and the recommended tax on workers' compensation benefits likewise would affect adversely those in great need.

The overall conclusion one must draw is that employee benefits are important to middle-, low- and no-income families and that proposals to further tax these benefits or provide obstacles to their growth will have a harsh impact on the lives of needy Americans.

Another misconception that fosters efforts further to tax employee benefits is the commonly held notion that the growth of employee benefits as a percentage of overall compensation in recent years means that ever-increasing amounts of benefit payments escape taxation; consequently, employee benefits must now be taxed in order to broaden the tax base. Such a conclusion is erroneous: A review of the statistical data shows that the majority of benefits are taxed already.

The U.S. Chamber's annual Employee Benefits Survey reports that in 1983, 36.6% of the average payroll was spent on employee benefits. However, that figure breaks down as follows: 9% of payroll was the employer's portion of legally required payments, such as FICA taxes; payments for time not worked, such as vacations, holidays and sick leave, which were fully taxed, accounted for another 9.4% of payroll; the remaining 18.2% was for benefits that one typically thinks of as employee benefits (e.g., pensions, life and health insurance, lump-sum death benefits). Much of the value of these benefits, however, such as pension payments, is not tax-exempt but simply tax-deferred. Indeed, EBRI calculates that tax-exempt employee benefits represent only 5% of total wages and salaries.

The move to subject benefits to further taxation, therefore, must be viewed within the context of their current taxation status; and we urge the Committee to do so as we analyze, below, the impact of new forms of taxation on these vital benefits.

III. HEALTH BENEFITS

The proposal to tax the first $10 per month (individual coverage) or $25 per month (family coverage) of health premiums provided by one's employer -- the so-called "tax floor" -- is fraught with problems. It involves serious questions of health policy within the context of tax reform.

health insurance is designed to make up a loss by restoring a patient's health. It does not add to an individual's personal enrichment. It has traditionally been a principle of tax policy that insured losses do not represent taxable income, and there is no reason to differentiate between loss of property or loss of health.

Moreover, there is no avoiding the fact that a health tax is a new tax on workers that will increase pressures for higher wages to offset the effect of subjecting these benefits to income taxation and payroll taxes. This increased taxation would partially offset any tax break enjoyed by the lower tax rates provided in the Administration's tax proposals. Of particular concern in this regard is the very real likelihood that the $10/$25 per month tax would be only threshold amounts, with the floor continually raised as future Congresses and Administrations search for ways to combat budget deficits.

Taxing heretofore tax-exempt health contributions invariably would induce many workers not to participate in group health plans. EBRI estimates that as many as 10 million Americans would forego health coverage if these benefits became fully taxed. It is easy to understand that many people, especially younger and healthier workers, could decide to give up coverage rather than pay tax on an unused benefit. The adverse results of reduced participation would be twofold.

First, as younger, healthier individuals left plans, the older, less healthy workers and those in higher health-risk job categories would more likely remain. As a result, the costs for coverage of this actuarially at-risk group would skyrocket. Employers would have to pay much higher premiums and, in order to continue group plans, employees would be required to pay a larger share of coinsurance or deductibles.

This would reduce real income for those employees and, no doubt, some of them would no longer participate in health coverage plans. A vicious cycle would ensue with higher premiums being matched by lower participation levels. Some employers, notably small businesses, would be forced to discontinue health coverage altogether, especially as its greater cost was combined with the higher payroll costs associated with subjecting health benefits to FICA and unemployment taxes and payroll-based insurance.

A second and equally unwelcome result of the health tax would be the increased cost to the government to pay for health care for those who went without coverage rather than pay the tax. No humane society allows its citizens to go without medical care, but the nearly universal private coverage would be replaced by increased levels of government-sponsored health care. As mentioned previously, some estimates conclude that the cost for the government to provide the same level of health care provided by the private sector would be three times as much.

Some observers warn of still a different kind of cost incurred by taxing health benefits. Most workers only use their health benefits rarely. Therefore, it is possible that among these workers a tax would increase the demand for unnecessary health treatments as they develop the attitude, "If I have to pay tax on these benefits, I'm going to use them to the fullest!"

Whether health coverage is overused or underused, the concept of relatively low-cost group coverage would be obviated, and both the taxpayer and the Treasury's coffers would be losers.

Quite apart from the general problems with taxing health benefits, the proposed tax floor presents special difficulties. These problems include the following:

1. A tax floor is totally regressive -- all workers with health insurance would pay tax, but the $10 or $25 taxable amount would disproportionately hurt the low-paid.

2. A tax floor discourages greater reliance on employee contribution to monthly health insurance premiums, which can be an effective cost containment feature of health plan design. This is the case because additional tax could be avoided by reducing the worker's wages by $10 or $25 per month and having the employer pay that amount toward the health plan in lieu of a like amount of employee contribution.

3. A tax floor is unlikely to raise the predicted revenues because of the avoidance efforts, described in #2 above, that likely would result.

4. A tax floor would be unduly harsh on workers who already make a large after-tax contribution to monthly health insurance premiums and, therefore, would pay tax on a portion of the employer-paid premium in addition to the amount of premium paid by the workers themselves.

Some proponents of a health care benefit tax argue that a "tax cap" -- taxing only amounts above a certain employer-provided level -- is advisable. We view this approach as equally undesirable as the "tax floor" since any tax is likely to have a negative impact on the cost and coverage of health benefits.

Some advocates of health benefits taxation insist that the current tax exemption is unfair since some individuals are not covered by employer-sponsored plans and, therefore, must buy insurance with after-tax dollars. However, current tax policy deliberately created this incentive to encourage employee group health plans. Presumably, this was done in recognition of the fact that private health coverage could be provided less expensively than government-paid coverage.

The result of this policy is that the vast majority of workers (96% in large- and medium-size firms) have employer-paid health coverage. In fact, more taxpayers benefit from the health insurance exclusion than from virtually any other tax preference -- including deductions for mortgage interest. Consequently, for most taxpayers any rate reduction attributable to taxing health benefits will nearly equally offset amounts raised from such a tax. Rather than tampering with the health tax exclusion which benefits an overwhelming percentage of Americans because of a perceived unfairness to those who do not enjoy the preference, efforts should be made to extend such vital private health protection to those who remain uncovered.

Some advocates of tax reform seek to use the tax code to mandate that private health care benefit plans cover certain individuals or types of health care services or that they reimburse at particular rates. Although mandated benefit proposals are not included in the President's tax reform proposal, discussion of them has become part of the tax reform debate.

In brief, we oppose federal or state requirements mandating health care benefit plan design or financing because they limit flexibility and raise costs. Private health plans have been successful because employers can tailor them to employee preferences and their own economic circumstances and because plans are readily redesigned in response to changed financial circumstances and information about efficient delivery of health care.

In contrast to the success of private health care benefits, federal health care programs have been cumbersome, bureaucratic, and difficult to make responsive to the health care market. Experience with these programs argues strongly against extending the rigidity of statutory mandates to private plans. In addition, the fact that decisions likely will be governed by political pressure rather than sound economics makes government intervention in health care benefit plan design a matter of great concern to employers.

Moreover, nearly all mandate proposals would raise the costs of health care benefits, just as voluntary private efforts to control such costs have begun to succeed. It is ironic that many of the authors of mandate proposals also advocate the tax cap, creating a "Catch-22" situation as mandates push plan costs closer to the tax limit.

IV. RETIREMENT SAVINGS

Compared to the other employee benefits elements of the tax proposals, pension and retirement savings provisions of the tax code appear at first glance relatively unscathed by the proposed changes. But a careful review of these proposals exposes provisions that would have a profound impact on the future of the private pension and retirement savings system.

At the outset it must be unequivocally stated that the pronounced goals of the retirement savings proposals, nondiscrimination in plan coverage and encouragement of savings for actual retirement needs, are laudatory and enjoy the support of the U.S. Chamber. However, the implementation of these provisions likely would have the opposite of the effect desired.

Many of the proposed changes inject further complexity into an already arcane area of law, and the result inevitably will be increased regulatory cost and burdens to comply with new requirements. Even worse, they will cause disincentives for employers to continue providing retirement savings coverage for the nation's work force. This will impose still greater pressure on the Social Security system to meet America's retirement income needs. A review of some of the more significant proposals is in order.

A. 401(k) Plans

Within the past few weeks the Administration harkened back to the November 1984 U.S. Treasury Department proposal and called for the elimination of 401(k) plans. The Chamber strongly opposes this backward step. Prohibiting these plans would deal a serious blow to a sensible and important retirement income program implemented by many employers on behalf of their employees.

Over 20 million American workers participate in 401(k) plans; nearly one-half million small businesses offer these plans to their 4.5 million employees. These plans are enormously popular and useful for ensuring adequate levels of retirement income security.

Even the less draconian May 1985 proposal for substantial restrictions is cause for concern. The Chamber believes the proposed rules regarding participation in 401(k) plans, as well as the proposed elimination of the availability of hardship withdrawals, taxation at ordinary income rates of an employee's withdrawals of after-tax contributions, and imposition of a 20% excise tax for pre-age 59-1/2 withdrawals, as well as a 10% excise tax for post-age 59-1/2 withdrawals deemed excessive, would all make such plans less attractive to many employers and employees.

The stated purpose of the restrictions on withdrawals is to ensure that 401(k) plan contributions are dedicated for retirement security needs. However, the unintended result of such changes would be reduced participation in such plans by lower- and middle-income employees for whom the availability of withdrawing the savings in case of an emergency is essential to participation. It would be an ironic and unfortunate twist of fate if the very same people -- lower-paid employees -- whose interests are most sought to be served by provisions of the tax proposals find that the prescribed practices for 401(k) plans so strictly tie up their savings that they are dissuaded from participation in the programs altogether. As a result, the plans could fail the nondiscrimination participation standards or not be offered at all.

Reducing the 401(k) contribution limit to $8,000 and then limiting combined Individual Retirement Account (IRA) and 401(k) contributions to that level not only will make 401(k) plans less popular but also will substantially increase the administrative burden for plan sponsors. Even if the ultimate responsibility for ensuring that combined 401(k) and IRA contributions stay below the minimum limit falls upon individuals, it will involve enormous administrative difficulty for employers to make projections of 401(k) contributions (which may change during a year as compensation levels change) so that their employees will not run afoul of the law. The $8,000 combined limit also would be especially troublesome for the employees of those businesses in which the 401(k) plan is the only type of retirement program offered.

However, it is the restrictive nature of the proposed participation and withdrawal rules that could sound the death knell for these plans.

Finally, eliminating the availability of 401(k) plan participation for employees of tax-exempt organizations is illogical. If the stated purpose of the existence of 401(k) plans is to encourage savings for retirement years, the tax status of one's employer should not be the factor determining whether one may participate in such a plan. Moreover, the premise upon which 401(k) plan participation is to be denied to employees of tax-exempt organizations -- availability of Tax Sheltered Annuities and Deferred Compensation Plans -- is inaccurate. Tax Sheltered Annuities are not permitted by law for many types of tax-exempt groups, and Deferred Compensation Plans do not contain all the beneficial features of 401(k) plans.

B. Uniform Coverage Rules

Under current law, qualified pension and profit-sharing plans are subject to coverage rules which allow employers flexibility in structuring employee benefits programs while at the same time precluding discriminatory delivery of such benefits. The Administration's tax reform proposal would impose uniform coverage requirements for qualified retirement plans and welfare benefits arrangements as well.

While the purpose of the new rules -- fair and equitable coverage -- is to be applauded, the resulting complexity and greater disincentive for employers to offer retirement and welfare coverage are a matter of real concern.

In addition, the proposed rules would be a reversal of health policy with respect to consumer choice of benefit plans. Current policy encourages consumer sensitivity to health care costs by encouraging employers to offer choices of benefit plans at different prices. For example, an employer may require employees to pay more per month for family coverage, and they may give a discount to employees who enroll in a Health Maintenance Organization or other managed cost delivery system. This array of choices is an effective cost management device.

However, the proposed rules effectively require that all different types of plans be offered at the same price -- or that there be only one plan -- because higher income employees may disproportionately elect to participate in plans with more generous benefits that are more costly to the employee. Such a result would eliminate this important incentive for employees to become prudent purchasers of health plans.

Furthermore, most small business and professional firms that offer health plans would have their plans disqualified where relatively highly paid employees are more than 25% of the work force - even if the firm covers all employees under the same plan at no charge to the employee. This rule augments the existing disincentives for small business to provide health plans.

The application of the uniform coverage rules could lead to the anomalous result that many large companies' plans lose their tax-qualified status even when all workers are covered, simply because all divisions of a controlled group of companies would be treated as one employer. This problem would be especially pronounced for those companies in multiple lines of business where industry practices provide for different types and levels of employee benefits.

Companies that offer flexible benefit programs designed to meet the particular needs of workers also would be severely hampered because each benefit offered would have to have the proper ratio of higher-paid and lower-paid participants. Thus, a plan that is considered nondiscriminatory one year could run afoul of the rule the next year, simply because not enough lower-paid employees elected a certain type of coverage.

As too often happens, small businesses would be inordinately inconvenienced by changes in the law. First, the sheer complexity and cost of implementing new rules would hurt disproportionately smaller firms with fewer resources, thus exacerbating the obstacles already in their paths for providing pension or welfare coverage. Second, a smaller company might find it more difficult to meet the nondiscrimination standards when it has only a few employees, some of whom are high paid and others low paid.

Ultimately, it will be lower-paid individuals who will suffer most -- by the absence of adequate coverage -- rather than the higher-paid individuals who are better positioned to provide for retirement or welfare coverage needs through alternative means.

The strict and uniform coverage rules are an anathema to a mobile and diverse work force that demands the flexibility of different types of benefits to meet legitimately different needs. The hallmark of nondiscrimination rules should be equality of availability of employee benefit plans to high-, middle- and low-paid workers, not equality of actual participation in a specific plan. Nondiscrimination rules should recognize this so that the private-sector delivery of benefits will flourish rather than be constrained.

C. Repeal of Ten-Year Averaging

The proposal to repeal the section of the Internal Revenue Code allowing lump-sum distributions from pension profit-sharing and stock bonus plans to be spread out over ten years for tax recognition purposes would impair the value of retirement benefits.

Some plans permit lump-sum distributions rather than life annuity benefits upon an individual's retirement. Currently, such benefits receive favorable tax treatment in the calculation of the amount of tax due. This tax treatment is particularly useful for those retirees who use their lump-sum payment for the purchase of some small enterprise or a retirement home that will be important to the individual in his retirement years.

Lump-sum payments especially are frequent when individuals are participants in more than one pension plan, due to employment in different companies. To repeal the ten-year averaging provision will certainly curtail retirees' flexibility and, in many instances, upset individuals' retirement plans contemplated prior to the current tax reform process. In addition, it will cause a considerable hardship for those retirees who, for perfectly legitimate reasons that serve their retirement security needs, elect a lump-sum distribution or who, if a plan is terminated, receive a lump-sum payment.

D. Reversion of Excess Pension Assets

The tax proposal would impose an excise tax upon the amount of assets reverting to a pension plan sponsor upon termination of a defined benefit pension plan. This issue of pension reversions has become a topic of much rhetoric but little understanding.

Certainly no one condones a practice that cheats a worker of his or her earned pension benefits. But the fact that an employer takes back excess assets that it contributed to a pension plan does not mean that pension plan participants are being denied benefits to which they are entitled. Before a company can take back excess assets, upon termination, all participants -- including those not yet vested -- immediately become vested in all benefits accrued to the date of termination. The plan administrator must ensure that all these benefits are guaranteed by assets of the plan -- generally through the purchase of annuities or payment of lump sum benefits.

If companies could not take back excess assets without a heavy tax, they likely would respond by underfunding plans in order to avoid this loss. The result would be detrimental to the stability of the pension system and the people who depend upon it for retirement security. In a sense, the ability of a company to take back its excess contributions to pension plans without a penalty tax is akin to 401(k) plan participants knowing they can withdraw plan contributions, if necessary, without the imposition of a heavy tax. The mere existence of the ability to take back contributions gives both sponsor and participant the confidence and incentive to contribute to such plans without fear that if unforeseen financial circumstances befall them, access to their own resources will be curtailed. Just as we believe that taxing early withdrawals from 401(k) plans will diminish their popularity, taxing pension reversions will cause sponsors to tend toward lower funding of such plans or cessation of defined benefit plans in favor of other kinds of retirement plans for their employees. The excise tax on reversions is a revenue-raising measure that is replete with dire consequences for the pension system.

E. Weakening the Private Retirement System

Many of the retirement savings provisions of the tax proposals will have extensive impact on substantive retirement practices that will weaken the employer-provided retirement system and impose greater responsibilities on the public sector. A number of the retirement provisions have little or no revenue impact on the overall tax proposals and, therefore, represent an effort to rewrite pension policy in the context of tax reform.

Encouraging the use of retirement plans for retirement purposes and ensuring fairness in the coverage of retirement plans are worthy goals. However, tax writers should not overlook the fact that retirement plans also provide vehicles for savings which are vitally necessary for economic growth. Policymakers also must recognize that overly rigid employee benefit plan rules will cause undue cost and administrative burdens to employer and employee alike. This will result in less extensive privately-provided coverage with disproportionate impacts on lower- and middle-income individuals.

V. UNEMPLOYMENT INSURANCE AND WORKERS' COMPENSATION

Nearly overlooked in the tax reform debate are the proposals to tax workers' compensation (WC) and unemployment insurance (UI) beyond the level at which they currently are taxed. Taxation of these benefits presents special concerns because they are required by law to be provided to employees. Elimination of the tax-favored status of these benefits would alter fundamentally one cornerstone of our long-held social policy involving the treatment given and protection awarded to the injured or unemployed worker.

Taxation of all UI and WC benefits will affect adversely both the beneficiaries and the business community. The impact of taxing individuals who are already in financially strained circumstances due to injury or unemployment is obvious. The impact on business is less clear on first glance but equally disadvantageous.

Since the states set benefit levels for both WC and UI, taxation of these benefits by the federal as well as state and local governments (since most state taxation policy mirrors that of the federal government) will require increases in outlays to offset such taxation solely to maintain current net benefit levels. For example, a recent actuarial study by the National Council on Compensation Insurance projects a 23% cost increase in WC to offset taxation.

Projecting UI payroll tax increases is more difficult because the Congress has twice previously mandated UI tax measures, in one case to raise revenue to fund another jobless pay extension. Currently, UI is taxed if an individual's earnings exceed $12,000 (single) or $18,000 (married). Nevertheless, employer UI payroll taxes will increase as states move to increase benefit levels to offset this additional taxation.

The partial wage replacement nature of both the UI and WC programs would be eroded seriously by further taxation because, by nature, partial wage replacement (and the formulae used by states to determine appropriate benefit levels) includes consideration of the tax-free status of the benefits. Partial wage replacement also provides incentives for both the unemployed or injured worker to return to work at the earliest possible moment.

To the extent WC is not wage replacement, but is a mandatory substitute for injured parties bringing tort suits for their injuries, taxing WC benefits is illogical and inconsistent with the nontaxability of tort awards.

The federal government has its own WC and UI programs, and benefits under these programs also would face similar outlay increases to maintain current net benefit levels. The increased benefit levels would be funded through increased payroll taxes in the case of UI and increased premiums in the case of WC. The resulting increased payroll burden will affect an employer's decision to hire additional workers, and this would be especially so for small businesses for which the payroll tax cost of workers plays a significant role in employment decisions. Both the UI and WC programs cost employers in excess of $20 billion annually, and increasing the payroll burden on employers (and, in turn, the ultimate costs to consumers of goods and services) will decrease the incentive to expand employment and exacerbate the problems of U.S. firms competing abroad.

VI. CONCLUSION

Few issues have so rallied the business and labor communities in a united stance as the proposals to tax employee benefits. Both realize that imposing new forms of taxation and a wide array of rules on employee benefits plans could be contrary to the worthy goals of tax reform: fairness, simplicity and growth. As Congress undertakes the critical task of tax reform, it should recognize the success of the private-sector employee benefit system and scrutinize carefully the effect of the tax proposals on our current health, retirement and social insurance policies.

Senator NICKLES. Mr. Alexander, thank you.

As usual before this committee, you make your comments very concise and right on target. I appreciate your comments.

There are a couple of quick things that I haven't touched on with section 401(k). Some people would mention, well, we don't need the section 401(k)'s to this extent because we are going to offer everyone the expanded option of the section 401(k), and that's really with the expanded IRA's.

Maybe we wouldn't need the extra availability because we are going to give everyone the tax-deferred option with an IRA. So it's not quite so necessary under the section 401(k) provision.

They can do it on their own if they so desire. Up to now, for a couple, if it went as proposed in Treasury II, up to $4,000.

What would your response be to that?

Ms. NAHRA. Well, I indicated I think there are advantages other than the pretax contributions that are offered by having the employer offer the section 401(k). For instance, taking away the responsibility of the employee for making investment decisions, having a professionally managed fund, having the payroll deduction vehicle.

A lot of people may think that they are going to put money away in an IRA, but when the time comes they in fact haven't saved that money. They haven't had a regular forced means of doing that; and the employer-provided payroll deduction to the section 401(k) plan is very helpful in that respect.

Senator NICKLES. Would you think that, through section 401(k)'s, you would actually be reaching down? You mentioned several in your company who participates. You mentioned a lot of participation of the lower- and middle-income status employees.

Do you think that would be more successful in reaching down to that class of employees versus the IRA's which, I think studies would probably show, lean more heavily toward the upper income levels?

Ms. NAHRA. Absolutely. I indicated nearly 70 percent of our nonexempt employees are participating in the section 401(k) now. While I haven't polled them, certainly some of the people in our department, I know, are newly participating in the section 401(k).

They did not participate in the after—tax—we did have an aftertax version—and they don't have an IRA. That's absolutely true.

Mr. ALEXANDER. I agree with that, Mr. Chairman. Employer participation is an essential ingredient. It's an ingredient in the section 401(k). It's not an ingredient in the Individual Retirement Account proposal.

The proposal is not a substitute for section 401(k). It may be a good idea.

One final point on that proposal. I see that the joint committee staff option that the Ways and Means Committee is considering is rejected. So if that rejection stands—if the committee adopts what has been called the chairman's options–why, then, the IRA won't be increased anyway; but, instead, the section 401(k) would be eliminated or cut back.

Senator NICKLES. They have a $5,000 cap?

Mr. ALEXANDER. $5,000 cap, apparently minus the IRA contribution. It doesn't leave much room in there, Mr. Chairman.

Senator NICKLES. If Congress went forward with something like that which would require an IRA offset and had a cap of $5,000, $6,000, $8,000, do you think that would greatly diminish an employee's and employer's willingness to set up the section 401(k)'s or a savings-type option?

Ms. NAHRA. I think it would greatly eliminate the IRAs and I think it's a mistake to have any sort of an offset. If you end up having a limit to the section 401(k)—let's take a $5,000 or $8,000 cap—then have it completely separate from the IRAs so that those, at least, who have more discretionary income can do both.

Otherwise, I perceive that individual IRA employees would participate in the section 401(k). Speaking for myself personally, I would drop my IRA and put the full amount in the section 401(k).

Senator NICKLES. I would do that option, as well.

Ms. NAHRA. So I am surprised that they are continuing to coordinate the two rather than to, if they are compelled to have some sort of a cap, have the cap separate from the IRA.

Senator NICKLES. To change the subject for just a brief moment, I haven't heard anyone mention the taxation on the lower end of health and accident. There are two theories going around, one taxing a base amount and the other is a cap or a limitation above which amount would be taxable income.

Would either of you care to suggest, if you had to pick between the two, what your alternative would be, or would it be just no taxation on health and accident benefits?

Ms. NAHRA. Well, I think our preference would clearly be no taxation. I think between the two, in the newest proposal that Ways and Means options have come out with where they put in a cap, they discuss having some sort of rules that would enable you to determine the value of your medical coverage.

If you were able to put in some rules that, for instance, made it more equitable to allow for the differences in cost among different geographical regions in the country or if you put in rules that would make it more equitable to allow for the differences in cost among different age groups, it would certainly make more sense from a health-care cost-containment standpoint.

The floor proposal is strictly a revenue-raising measure, if they must do that, but it makes absolutely no sense from a health-care cost-containment standpoint at all.

Senator NICKLES. Mr. Alexander.

Mr. ALEXANDER. Mr. Chairman, the chamber would agree with that. The chamber does not like the floor proposal. It is discussed at some length on pages 2 through 8 of the chamber's statement.

The chamber also opposes the cap that was first proposed and is proposed again in the staff option.

Senator NICKLES. I would just make one comment, and again maybe wearing my employer cap.

Health-cost containment, no doubt, would be better served by a cap instead of a floor. There is no incentive whatsoever under the floor proposal, except for raising revenues, mentioned.

But the cap proposal is very hard to define because you have a great number of employers who are self-insuring, et cetera, and it's very difficult to know what your costs are going to be. Therefore, how do you ascertain what the costs are, what the tax liability would be, until the end of the year, which is kind of hard to set.

That's easier said than done as far as implementing the cap proposal if you are using self-insurance and some outside insurance, major-med insurance, et cetera.

I appreciate the comments of the panel. Thank you very much.

Our next ponelists are Harold Schaitberger, director of governmental affairs and public relations for the International Association of Firefighters and Karen Ferguson, director of the Pension Rights Center.

Mr. Schaitberger, welcome again to the committee.

Mr. SCHAITBERGER. Thank you, Mr. Chairman.

Senator NICKLES. We have been working with you on Garcia and a few other little cases. I will take this half a second to tell you I want to work with you further and see if we can't resolve some of those issues on Garica, hopefully in the not too distant future.

Mr. SCHAITBERGER. Well, we are addressing that now. We look forward to continued work with you and your staff to resolve these issues.

Senator NICKLES. Thank you. Please proceed.

Mr. SCHAITBERGER. Mr. Chairman, I will summarize the statement which we have submitted to your committee and hope that it would be placed in its entirety in the record.

STATEMENTS OF HAROLD A. SCHAITBERGER, DIRECTOR, GOVERNMENTAL AFFAIRS AND PUBLIC RELATIONS, INTERNATIONAL ASSOCIATION OF FIREFIGHTERS; AND KAREN FERGUSON, DIRECTOR, PENSION RIGHTS CENTER.

Mr. SCHAITBERGER. The International Association of Fire fighters represents 170,000 professional firefighters throughout the United States and Canada.

We appreciate this opportunity to be able to appear before you today to discuss the President's tax proposals, and specifically how they could change and affect retirement plans for firefighters and other public employees throughout the country.

It is important at the outset for me to impress upon the subcommittee that the professional firefighters of this country have established, built upon and benefited from their requirement systems, which have allowed for hard-earned and well-deserved retirement periods.

Our members are not high-salaried professionals looking for ways for sheltering large amounts of income to avoid income tax. My remarks, I would hope, would be viewed from this basis.

Previous Congresses have, on several occasions, enacted corrective legislation to remedy what appeared to be abuses of the Internal Revenue Code provisions designed to give tax favorable treatment to bona fide retirement programs. When Congress amended these sections to close perceived loopholes, they in fact restricted the distribution of legitimate benefits for retirees, their dependents and their surviving spouses.

Congress was again in the position of enacting even more legislation to correct those unintended effects.

In reviewing the President's more recent proposal for tax simplification reform, we find several glaring recommendations that would, again, severely harm public employees, middle-class workers, and the income security of millions of retirees throughout the country.

Our goal today is to assist the Congress in avoiding similar mistakes which have been made in the past.

I would now like to briefly discuss several proposals we consider most alarming. The IAFF, first, strongly opposes the elimination of current deductions allowed for State, local, and municipal government taxes.

The repeal of State and local taxes will indisputably lead to the diminution of vital services for a great percentage of Americans. Public education, municipal sanitation service, fire protection, law enforcement activities, and the ability to fund the retirement programs of these employees of those services will eventually be impaired in many of our States and localities.

Clearly, strong pressure will be brought to bear upon State representatives to cut taxes if the current tax deductibility is repealed. It is startling that after President Reagan instituted his New Federalism, in 1981, shifting the burden of providing vital services to State and local governments, he would now cut the ability of the support system that provides the resources needed to maintain and enhance these services.

This proposal will limit resources available for maintaining public services and, more importantly for the concerns of this subcommittee today, the ability of State and local governments to adequately fund the retirement programs of their employees.

Another proposal, section 1402 of the President's plan, would establish a 20 percent excise tax on any nondisability retirement received from a tax-favored plan prior to the recipient's age of 59½. In simple terms, this means that a firefighter, retiring on a modest $15,000-a-year annual retirement annuity after 25 years of service, would be subject to a $3,000 tax which, in itself, is not deductible.

In addition, the entire $15,000 would still be subject to Federal and State income tax.

Again, in simple terms, this individual's modest retirement income after years of dedicated public service in the most dangerous profession in the Nation would be subect to thousands of dollars of benefit reduction due to this provision.

The IAFF strongly objects to the excise tax penalty for distributions for retirement benefits. Public safety workers have earned and deserve the retirement benefits they are currently entitled to and which have been promised at the time of employment without the penalty this provision would impose.

Section 3.06 of the proposal would eliminate the tax exclusion for current benefits received as worker's compensation or disability retirement benefits in lieu of workers' compensation. The IAFF strongly opposes the elimination of this income exclusion, which assists workers who have incurred disabilities while engaged in public service work.

This proposal would prohibit them from maintaining a standard-of-living comparative to that which they enjoyed prior to incurring the disability.

The Internal Revenue Service already taxes benefits received for disability not incurred in the line of duty. It would seem terribly unfair and unjust to now penalize individuals who have incurred disabling injuries in the course of the performance of their duty by eliminating the current tax-exempt status.

I would also like to highlight and underline the chairman's concerning the double taxation which would exist if these current proposals were to be enacted. As you mentioned, the contributions that an employee pays, which are aftertax dollars, are now received in the form of benefits and excluded from taxation until your benefit exceeds those number of dollars.

For the Congress and the Government, now, to tax those same dollars twice is clearly double taxation.

It seems to us, first, we would hope that this proposal would be eliminated; but, at least, if the proposal were to remain intact, a deduction for contributions should then be forthcoming.

I would also like to mention to the chairman that we still have a serious problem with the 415 limitations which were created in TEFRA. As the Congress and this committee addresses the proposal, we believe that the 415 limitations should be lifted for public safety workers.

The limitations enacted in 1982 were to attempt to fill what was a loophole for high-salaried individuals who could use their defined-benefit and contribution plans to shelter large amounts of income; but, by applying the actuarial reduction cap imposed in 1982, starting at the age of 62 down to age 40, you catch in that net public safety workers who are normally retired and expect to be able to retire after 25 and 30 years of service.

Now, that cap artificially prevents them from receiving the retirement benefits to which they were entitled and expected at the time of their employment.

In conclusion, Mr. Chairman, it is not the position nor the responsibility of the IAFF to understand the tax implications for all sectors of our economy. We do, however, have the responsibility for protecting and enhancing the retirement income security of professional firefighters throughout the United States.

The administration's current proposals would severely harm not only our public membership, but also middle-income workers who rely on their retirement plans to enjoy some dignity and security during their retirement years.

While reviewing the President's plan, we ask the subcommittee not to view the plan's proposal only as a way for eliminating possible abuse and misuse of high-income and salaried individuals: we suggest you determine how they would affect an integral component of the total compensation package for millions of workers who have served their States, localities and the Nation during their years of public service.

Thank you.

[The prepared statement of Mr. Schaitberger follows:]

TESTIMONY
BEFORE THE
SENATE LABOR SUBCOMMITTEE
ON
PRESIDENT REAGAN'S PROPOSAL FOR COMPREHENSIVE TAX REFORM AND ITS EFFECT ON PENSION PLANS

October 1, 1985

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Mr. Chairman, members of this distinguished subcommittee, my name is Harold A. Schaitberger. I am the Director of the Department of Governmental Affairs and Public Relations for the International Association of Fire Fighters, AFL-CIO-CLC, representing more than 170,000 professional fire fighters throughout the country. I would like to thank you for the opportunity to discuss our President's tax proposals and specifically how the change will affect the retirement plans of fire fighters and other public employees.

It is most important at the outset for me to impress upon the subcommittee that professional fire fighters have established, built upon and benifitted from their own retirement systems, which allow for a hard earned and well deserved retirement period. Public workers are not high salaried professionals looking for ways of sheltering large amounts of income to avoid income tax. Our remarks should be viewed from this basis.

Previous Congresses have, on several occasions, enacted corrective legislation to remedy what appeared to be abuses of Internal Revenue Code provisions designed to give tax favorable treatment to bona fide retirement programs. When Congress amended these sections to close perceived loopholes, they, in fact, restricted the distribution of legitimate benefits for retirees, their dependents and their surviving dependents. Congress was again in the position of enacting even more legislation to correct these unintended effects.

In reviewing the President's most recent proposal for tax simplification and reform, we find several glaring recommendations which would again severely harm public employees, middle class workers, and the income security of millions of retirees throughout the country. Our goal today is to assist this Committee in avoiding similar mistakes which have been made in the past.

In reviewing the current tax proposals under consideration by your Committee, it is important to state that the IAFF believes all Americans support a fair tax structure. Unfortunately, most Americans are convinced that tax legislation is crafted by special interests other than their own and that avoidance and evasion is the name of the game.

The Congress, Mr. Chairman, has the opportunity to develop a less complex, understandable and equitable tax code. While we laud your efforts, we nevertheless have several reservations that some aspects of the President's tax proposals will result in less than "fairness, growth, and simplicity" despite the repetitious statements from the President that "a second revolution has arrived, that insures tax equity for all." The provisions recommended by the Administration would severely restrict the retirement benefits earned by millions of American workers. They would further penalize workers who have entered into public service looking forward to a reasonable and secure retirement period at the conclusion of their working years.

I would now like to briefly discuss several proposals which we consider most alarming.

* The IAFF strongly opposes the elimination of current deductions allowed for state, local, and municipal government taxes. We believe this proposal is based on a shortsighted theory that the repeal is warranted because the deduction for state and local taxes benefits a small minority of U.S. taxpayers at the expense of the great majority of Americans. Like it or not, the tax system encourages and conversely discourages particular policies for society to pursue. The tax system has been an important vehicle for achieving vital social, and economic objectives.

The repeal of state and local taxes will indisputably lead to a diminution of vital services for a great percentage of Americans. Public education, municipal sanitation service, fire protection, law enforcement activities, and the ability to fund the retirement programs of the employees of those services will eventually be impaired in many of our states and localities. Clearly, strong pressure will be brought to bear upon state representatives to cut taxes if the current deductibility is repealed. In human terms rather than tax jargon the loss of such vital services is potentially catastrophic. No one needs to be reminded that without a quality education system millions of our fellow citizens will not be able to propel themselves out of the quagmire of poverty that sadly engulfs and destroys the productive capacity of large sectors of our nation, and I need not dwell on the importance of maintaining adequate fire and police protection.

It is startling that after President Reagan instituted his new federalism in 1981, shifting the burden of providing vital services to state and local governments, he would now cut the ability of the support system that provides the resources needed to maintain and enhance these services. This proposal will limit resources available for maintaining public services and the ability of state and local governments to adequately fund the retirement programs of its employees will become difficult at best.

* Section 14.02 of the President's proposal would establish a 20% excise tax on any nondisability retirement benefit received from a tax favored plan prior to the recipients age of 59½. This tax could be reduced to 10% if the individual uses the distribution for the purchase of a first primary residence, for the college education of a dependent, or to replace unemployment benefits during a period of unemployment. However, prior to the age of 50, regardless of the use of the distributions the full 20% excise tax would be applicable. In simple terms this means that a fire fighter, retiring on a modest $15,000 annual retirement annuity after 25 years of service, would be subject to a $3,000 tax which in itself is not deductible. In addition, the entire $15,000 would still be subject to federal and state income tax.

In simple terms, an individual's modest retirment income after years of dedicated public service in the most dangerous profession in the nation, would be subject to thousands of dollars of benefit reduction due to this provision. The provision further requires a 20% excise tax on any disbursements from a plan which would provide benefits under a certain time period if that time period is less than 180 months in duration.

The IAFF strongly objects to the excise tax penalty for distributions for retirement benefits. Many public employees such as law enforcement officers and fire fighters normally retire at ages prior to 59½. Serving 25 or 30 years in these professions is physically demanding and emotionally stressful. Public safety workers have earned and deserve the retirement benefits they are currently entitled to and which have been promised at time of employment, without the penalty this provision would impose.

It is our opinion that the Administration seeks to impose this provision in order to raise the age at which all workers begin to retire. Some Administration officials have suggested that many high salary professionals may use their tax favored plans as a tax sheltering device receiving a retirement benefit that in fact is not retirement income but simply deferred compensation. I can assure you that for the millions of workers in the public sector this is not the case. Their retirement programs are designed to provide public workers with reasonable retirement benefits and financial security at the end of their period of public service.

* Section 3.06 of the proposal would eliminate the current tax exclusion for current benefits received as worker's compensation or disability retirement benefits received in lieu of worker's compensation. The IAFF strongly opposes the elimination of this income exclusion which assists workers who have incurred disability while engaged in public service work. This proposal would prohibit them from maintaining a standard of living comparative to that which they enjoyed prior to incurring their disability. The Internal Revenue Service already taxes benefits received for disability not incurred in the line of duty. It would seem terribly unfair and unjust to penalize individuals who have incurred disabling injuries in the course of performance of duty by eliminating the current tax exempt status.

* The current Administration's proposal has reduced the original recommendations contained in its November tax reform package regarding the taxing of employer paid health and life insurance benefits. However, we continue to have serious reservation about the taxation of any employer paid benefits. First, we would prefer to use the term employer paid benefits instead of the term most often used by the administration - fringe benefits. The use of the term fringe benefits, while referring to employer sponsored plans, enormously understates the importance of these plans which provide basic health security for employees and their families in all income brackets and are available to the vast majority of Americans. Let us start by eliminating any thought that employer paid benefits are only availabe to a few Americans. Preliminary data released by the Employee Benefit Research Institute shows that

approximately 90% of public sector employees are covered by pension, medical, and insurance programs. Other surveyed industries that have higher employer pension, medical, and insurance plan participation rates include manufacturing, public utilities, real estate, finance, insurance, and communications.

The current tax proposal rationalizes that employees' fringe benefits such as health care leads to over consumption of health services. The Treasury Department noted and I quote, "Health care is made much more expensive for all because it is effectively subsidized through the tax system for some. The tax advantage now accorded some fringe benefits causes more of them to be consumed." This logic which is based on the market solution theory argues that if a product cost more the use of it will naturally decrease. While some economists may not argue with this logic, it must be remembered that many economists have never scored high marks on compassion and equity. In the area of health care the major cost is surgery, which obviously no one can avoid or predict. Simply put, health care is a vital necessity. Those who have good plans should not be penalized through our tax system. Rather, those who do not provide the basic plans should be encouraged to do so.

Section 301 of the new proposal requires an employee with a spouse or a dependent to add $300 to his or her tax liability. An estimated $15 billion dollars will be raised by such taxes by 1990. Yet, realistically this proposal must be viewed for what it is - a wolf in sheep's clothing. If an employee's health benefits are taxed today, tomorrow those benefits will be taxed to a greater extent and taxation of other benefits such as the contributions made by employers into employees retirement programs will soon follow suit. Ultimately, the original objective of Congress to extend basic services to millions of Americans will be circumvented. If monies which are currently directed toward employee benefit program plans are taxed as income, younger workers will not be inclined or encouraged to allow those funds to be used in providing basic health, life and retirement security. They may foolishly choose to take those funds in direct compensation rather than plan for the future. Should this take place how long will it be before the Federal Government and other levels of government will be looked upon to provide essential health care that individuals no longer have provided for themselves.

Section 4.05 of the Administration's proposal would repeal the current income averaging provision provided for individuals whose income varies widely from year to year. Currently, if an individual's income for the taxable year exceeds 140% of average income for the 3 preceeding years, the effective tax rate applicable to such excess income generally will be the rate that would apply to 1/4 of the averageable income. The elimination of this provision would hurt many public workers who are forced to relocate and change employment. For example: many public workers prior to their retirement vesting date are allowed or required to withdraw their pension contributions plus interest in a lump sum distribution. These individuals, without the income averaging rule, would be required to pay income tax on that amount in addition to their annual salary. Therefore, the IAFF would recommend that the Congress modify the current proposal which would repeal income averaging to allow averaging to apply to lump sum distributions derived from defined benefit or defined contribution retirement plans.

The IAFF understands that Congress will be hearing from hundreds of special interest groups asking it to modify current proposals contained in the President's plan or other tax reform measures so as to minimize the effect on their own interest. We additionally understand that to maintain credibility in this legislative process, an effort should be made by each group asking for modification of provisions which would eliminate or reduce revenues to offer suggestions as to how those revenues can be replaced. In that spirit the International Association of Fire Fighters is prepared to suggest a few ways in which the Congress can shape a tax reform package that will move more decisively toward tax justice without the revenue loss of the President's current proposal and without doing great harm to thousands of Americans, who have worked toward and expect a fair pension system.

In conclusion, Mr. Chairman, it is not the position nor the responsibility of the International Association of Fire Fighters to understand the tax implications for all sectors of our economy. We do, however, have the responsibility for protecting and enhancing the retirement income security of professional fire fighters throughout the United States. The Administration's current proposals, would severely harm not only our public membership but also middle income workers who rely on their retirement plans to enjoy some dignity and security during their retirement years. While reviewing the President's plan, we ask that the Subcommittee not view the plans' proposals only as a way for eliminating possible abuse and misuse by high income and salaried individuals. We suggest you determine how they would effect an integral component of the total compensation package for millions of public workers who have served their states, localities and nation during their years of public service. We stand ready to answer any questions the Subcommittee may have and look forward to working with you and your staff in developing a fair, equitable and simplified reform package.

Senator NICKLES. Thank you very much, Mr. Schaitberger.

Ms. Ferguson.

Ms. FERGUSON. Good morning, Mr. Chairman. I am Karen Ferguson, director of the Pension Rights Center.

With your permission, I would like to summarize our prepared statement.

Senator NICKLES. Thank you.

Ms. FERGUSON. The statement will be limited to our support of the Treasury's proposal to repeal 401(k) plans.

The Treasury has taken the position that the repeal of 401(k) plans would represent sound tax policy. We think that this proposal also represents sound pension policy.

Before turning to the pension policy issues, I would like very briefly to summarize the relevant tax policy considerations.

The principal tax consideration is, of course, that 401(k) plans—if they are not repealed—will cost the Treasury an estimated $16 to $18 billion in lost revenues over the next 4 years. This is of particular concern to the Treasury since a very substantial portion of this loss will come from amounts that would have been saved without a tax subsidy.

We note in our prepared statement that a recent survey by a consulting firm showed that two-thirds of the 401(k) plans in that study were converted thrift or profit sharing plans.

Also of great concern from a tax policy perspective is the fact that the money now being saved in 401(k) plans has not been contributed for the purpose of saving for retirement. Employees are contributing to 401(k) plans because they are extraordinarily attractive tax shelters and because, typically, they can use the money contributed to save for housing and medical emergencies, and for their children's college education.

The argument that even though the money has not been contributed for retirement income purposes it will, nonetheless, not be withdrawn before retirement just doesn't make sense. If money is being saved for a child's tuition, it will be spent for that purpose.

The relatively low withdrawal rates, thus far, demonstrate nothing more than the fact that these 401(k) plans are very new; $3,000, for example, accumulated over the past 3 years would not go very far toward the purchase of a house.

From a tax equity perspective, the question is: Why should all American taxpayers pay higher taxes to subsidize 401(k) plans? This higher tax burden is justified only if these plans are an efficient way of encouraging employers to provide lower and moderate income workers with retirement income.

Thus far, the evidence is that 401(k) plans disproportionately benefit the higher paid. Lower and moderate income employees are either not able to contribute anything at all for retirement income purposes, or in the case of older workers, are only able to contribute small amounts too late in their work lives to provide a significant source of retirement income.

But aside from these tax considerations, are there strong countervailing retirement income objectives that would be undercut by the repeal of 401(k) plans? We do not think that there are.

This morning, you have heard and will hear testimony that 401(k)'s are the only possible source of retirement income for employees working for small employers. You will also hear, and have heard, that 401(k)'s are the only possible source of retirement income for mobile employees, minorities, women, others covered by private pension plans who will receive little or no benefit from those plans because of the plans' vesting and integration rules.

The reality is that, in fact, there are other, more realistic sources of retirement income for both of these groups—those working for small employers who have no plans and those working for larger employers that will not benefit from their employers' plans.

Looking first at the small employers, we certainly agree that many small companies that did not have pension plans have now set up 401(k) plans. We also agree that many of these employers did not set up pension plans because of the administrative expenses and the paperwork burdens frequently associated with small company defined benefit plans.

But this does not mean that 401(k) plans are the only alternative available to small employers. SEP's [Simplified Employee Plans] are far more efficient vehicles for providing retirement income to employees working for small employers.

SEP's allow employers to contribute the same amounts as in a 401(k) plan, and there are no administrative costs or paperwork burdens if the employer follows the IRS model SEP plan.

The advantages of a SEP from a retirement income perspective are that: Contributions to simplified employee plan are made directly by the employer rather than by reducing the employee's salary; contributions must be made for virtually all employees; and the contributions are payable only for retirement income purposes.

The only problem with SEP's is that almost nobody knows about them. The reason for this is simply that neither the plan consultants nor the insurance companies that have traditionally sold plans to small employers have any financial incentive to sell SEP's.

They're too simple, too straightforward. The only costs of a model SEP are the benefit costs.

The Pension Rights Center is now preparing a pamphlet to explain to employees why they may want to try to persuade their employers to set up SEP's, and other institutions are about to start major SEP promotion campaigns directed at employers. We anticipate that within a year everybody will know about SEP's.

But what about the argument that 401(k) plans are the only alternative for employees in larger plans who are not going to get benefits from those plans?

There are certainly millions of employees working for larger companies who will not receive benefits from their companies' pension plans. Typically, they will lose out because they will not stay with the company long enough to vest in their pension; or, if they vest, they will be integrated out of benefits under the plan's rules.

A far more efficient and cost-effective method for providing retirement income for these employees is not through a voluntary savings plan, but through their own existing company pension plans.

There is already a broad consensus on the part of many business and labor groups in support of the modest vesting and integration reforms soon to be introduced by Senator John Heinz and Congressman William Clay as part of their Retirement Income Policy Act of 1985.

Enactment of vesting and integration reforms in pension plans would do a great deal more for workers in these plans than could ever be achieved by 401(k) plans.

Mr. Chairman, our greatest concern about 401(k) plans is one you hinted at earlier: that they could actually detract from the economic security of future retirees.

We have been told by actuaries and lawyers that none of their clients who have set up 401(k) plans to supplement preexisting pension plans have voluntarily improved their pension plans since the establishment of the 401(k) plans despite the fact that these employers had consistently improved their plans in the past.

Even more disturbing is the fact that we are hearing from an increasing number of employees whose employers have actually terminated their pension plans and substituted 401(k) plans.

If, as we suspect, this is a widespread phenomenon, if 401(k) plans are precipitating a trend toward freezing or even terminating pension plans, there could be no more persuasive argument for immediate repeal of 401(k) plans.

Finally, in conclusion I would like to say that we are very, very much aware the 401(k) plans are extremely popular, popularity should not be determinative of an issue of such far-reaching consequences to current taxpayers and to future retirees.

Thank you.

[The prepared statement of Ms. Ferguson follows:]

STATEMENT OF KAREN W. FERGUSON
PENSION RIGHTS CENTER
BEFORE THE SENATE SUBCOMMITTEE ON LABOR
OCTOBER 1, 1985

Mr. Chairman, Members of the Subcommittee, I am Karen W. Ferguson, Director of the Pension Rights Center. The Center is a nonprofit public interest group that has been working for nearly a decade to make the nation's pension system fair and responsive to the needs of workers and retirees. We appreciate your invitation to testify this morning. Our statement will be limited to support of the Treasury's proposal to repeal 401(k) plans.

The Treasury has taken the position that the repeal of 401(k) plans would represent sound tax policy. The purpose of this hearing is, in part, to determine whether this proposal also represents sound pension policy. We think that it does.

Before turning to the pension policy issues that are the principal concern of this Subcommittee, I would like briefly to summarize the relevant tax policy considerations. These reduce to concerns about tax revenue and tax equity.

Tax Policy Considerations

Tax Revenue Considerations Justifying the Repeal of 401(k) Plans

The principal tax revenue consideration is that, if 401(k) plans are not repealed, they will cost the Treasury an estimated $16 to $18 billion in lost revenues between 1986 and 1990.

Moreover, a very substantial portion of this loss will result from the deferral of taxes on amounts that would have been saved in the absence of the tax subsidy afforded to 401(k) plans. These are amounts that employees would have saved in thrift plans and in other non-tax-subsidized forms of investments.[1]

Also, most money now being saved in 401(k) plans has not been contributed for the purpose of meeting retirement income needs.[2] Employees are contributing to 401(k) plans because they are extraordinarily attractive tax shelters and because typically they can use the money contributed to save for housing and medical emergencies and for their children's college educations. In addition, they are contributing because they know that they can cash out their contributions when they stop working for the company sponsoring the plan and, in many instances, that they can borrow from the plan.[3]

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[1] A 1985 Survey of 401(k) Plans by the consulting firm of Towers, Perrin, Forster and Crosby, shows that 66.2% of the plans surveyed were converted from existing thrift or profit-sharing plans (p. 2).

[2] The Towers, Perrin study, *supra* n. 1, reports that "Retirement needs" was by far the least significant of the "[f]actors most responsible for encouraging 401(k) deferrals by the lower paid 2/3 of employees," only 2.2% as contrasted with "Tax savings," 83.4% (p. 5).

[3] Some employers and consultants have argued that even though employees do not contribute to 401(k) plans for the purpose of meeting retirement income needs, these needs will nonetheless be met because, despite their intentions, employees will not in fact withdraw their money before retirement. In support of their contention they point to the relatively low withdrawal rates in plans they have surveyed.

(continued)

Tax Equity Considerations Warranting Repeal of 401(k) Plans

There are also strong tax equity considerations that warrant repeal of 401(k) plans. A federal tax expenditure, such as the tax breaks for 401(k) plans, requires all American taxpayers to pay higher taxes to subsidize a particular activity. This higher tax burden is justified only if the subsidized activity represents an efficient way of achieving an important social objective. In the case of employer-sponsored plans, this objective is to encourage employers to provide lower and moderate income workers with the income they will need to supplement social security in retirement.[4] Employer-sponsored plans are viewed as achieving this objective only if they are structured to provide benefits on a nondiscriminatory basis to lower income employees.

Unlike other employer-sponsored plans, 401(k) plans tend disproportionately to benefit the higher paid. Upper income and

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[3] (continued)
These rates indicate nothing more than that the plans surveyed are very new. Most are no more than 3 years old. The amounts accumulated over such a short time are not, in most instances, sufficient to pay for a college education or a house. Moreover, an employee who contributes to a 401(k) for the sole purpose of paying a child's college tuition is going to have to use that money for that purpose when the child reaches college age. Unless he or she wins the lottery or comes into an inheritance, there will be no alternative.

[4] "Presumably, it is the difficulty of anticipating many years in advance what one's needs will be in retirement" that justifies the distinction in tax treatment of retirement savings and savings for other purposes. Statement of Daniel I. Halperin before the Senate Committee on Finance, July 11, 1985, p. 2.

upper middle income employees are able to contribute substantial amounts at very considerable tax savings[5] while lower and moderate income employees, the employees that the tax expenditure is designed to benefit, are either not able to contribute anything at all for retirement income purposes or, in the case of older workers, are only able to contribute small amounts too late in their work lives to provide a significant source of income.[6]

Retirement Policy Considerations

While the arguments against 401(k)s are extremely compelling looked at solely from a tax policy perspective, are there strong countervailing retirement income objectives that would be undercut by the repeal of 401(k) plans? That is the issue you are addressing this morning.

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[5] Under current rules, they have the ability to reduce their taxable income by up to $30,000 a year, and defer taxes on plan investment earnings, a substantial benefit at high marginal tax rates.

[6] The Towers, Perrin survey and a similar 1985 survey by Hewitt Associates seek to document that "lower paid" employees are participating in 401(k) plans. Both are surveys of larger plans that generally exclude rank and file unionized employees. Their "breakpoint" to determine who is "lower paid" for purposes of the IRS nondiscrimination tests is an income of $30,000. In both surveys only slightly more than half of these "lower paid" employees participated in their companies' 401(k) plans. The Hewitt study stated that participation was predominantly by older employees. There was no indication in either study as to how many participants were "second earners." The only conclusions that can be drawn from these studies is that older, white collar, middle income employees are participating in these plans.

Opponents of the Treasury's proposal are arguing that 401(k)s are essential to meet the nation's retirement income needs. They contend that

- 401(k)s are the only possible source of private sector retirement income for employees working for small employers, and that
- 401(k)s are the only possible source of private sector retirement income for those mobile employees, minorities, and women who are covered by private pension plans but will receive little or no benefits because of their plans' "vesting" and "integration" rules.

If these arguments were valid, we would agree that tax policy considerations should not necessarily be decisive of the future of 401(k) plans. However, we do not find them persuasive. In fact, there are other, more realistic, sources of retirement income for both groups of employees.

401(k) Plans Are Not the Only Alternative for Employees Working for Small Companies

It is certainly true that many small companies that did not have pension plans have now set up 401(k) plans. It is also undoubtedly true that most of these employers did not set up pension plans because of the administrative expenses and paperwork burdens frequently associated with small company defined benefit plans. There is the further fact that these plans require a continuing commitment by the employer to fund the benefits promised by the plan, a commitment that smaller employers are often reluctant to undertake. This, however, does not mean that 401(k) plans are the only alternative available to small employers interested in meeting their employees' retirement income needs. They are not.

Simplified Employee Plans are far more efficient vehicles for providing retirement income to employees working for small companies. SEPs have the same $30,000 a year contribution limit for employers as 401(k) plans, and if an employer adopts the Internal Revenue Service's Model SEP plan, there are no administrative costs or paperwork burdens. There is also no continuing contribution obligation (an employer can contribute different amounts in future years or nothing at all.) What distinguishes a SEP from a 401(k) plan is:

(1) that contributions are made directly by the employer rather than by reducing employees' salaries,

(2) that the contributions must be made for virtually all employees, and

(3) that the contributions are payable only for retirement income purposes (or at death or disability).

While SEPs are the most equitable retirement plan available to smaller employers, few employers are aware of their existence. This is because neither the plan consultants nor the insurance companies that have traditionally "sold" plans to small employers have any financial incentive to sell SEPs. They are too simple and too straightforward. Money that in a 401(k) plan goes to ensure compliance with complex discrimination requirements and individual investment choices, goes directly to IRA accounts selected by employees. The only costs of a Model SEP are the benefit costs.

In recent months other institutions have begun promoting SEPs to employers, and we are now finishing work on a pamphlet that will explain SEPs to employees. We anticipate that within a year virtually all small employers — and their employees — will be very much aware of this important alternative.

401(k) Plans Are Not the Only Alternative for Mobile Employees, Minorities, and Women Working for Larger Companies.

There are certainly millions of employees working for medium size and large employers who will not receive benefits from their companies' pension plans either because they will not stay with the company long enough to "vest" in their pension or, if they vest, because they will be "integrated out" of benefits under their plans' rules.[7] But a voluntary savings plan is neither a realistic approach nor the only approach to providing these employees with an adequate retirement income.

This group of employees — with the possible exception of mobile professional employees — is far less likely to be in a financial position to take advantage of a voluntary savings plan than the longer service, higher paid employees who receive benefits from their companies' pension plans. 401(k) plans will increase rather than diminish the disparities between these two groups.

A far better alternative for this group would be for their pension plans to be improved so that they provide more benefits to more people. (In this connection it would be helpful to know how much in the way of vesting and integration improvements could be "bought" with money now going into administrative costs and employer "matches" in typical larger company plans.)

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[7] According to the Bureau of Labor Statistics, 87% of all full-time participants working for medium size and large firms are covered by plans that require 10 years to earn any pension benefits; 55% are covered by plans that use formulas integrating pension benefits with social security. In some instances, this can cause shorter service, lower paid employees to lose all pension benefits.

As you may be aware, Title I of the Economic Equity Act of 1985 calls for modest vesting and integration reforms. There is, moreover, a broad consensus on the part of many business and labor groups in support of similiar measures soon to be introduced by Senator John Heinz and Congressman William Clay as part of the Retirement Adequacy Act of 1985. Enactment of vesting and integration reforms would be the single most efficient and cost effective method of enhancing the retirement income security of American workers.

The Long-Range Retirement Income Policy Implications of Not Repealing 401(k) Plans Could be Disastrous

We are concerned that continuation of 401(k) plans could substantially detract from the economic security of future retirees.

Actuaries and lawyers have told us that none of their clients who have set up 401(k) plans to supplement preexisting pension plans have voluntarily improved their pension plans since the establishment of the 401(k)s, despite the fact that these employers had regularly improved their pension plans in the past.

Even more disturbing is the fact that we are hearing from an increasing number of employees whose employers have terminated their pension plans and substituted 401(k) plans.

Is this a widespread phenomenon? We do not know. If 401(k)s are precipitating a trend toward freezing or terminating pension plans, there could be no more persuasive argument for immediate repeal of 401(k) plans. We urge this Subcommittee to consider undertaking a study to determine whether there is such a trend. While increased reliance on "individual initiative" may be philosophically appealing, it is both impractical and inappropriate in a retirement income context. No one has ever shown that do-it-yourself retirement arrangements can "do the job" of providing lower and moderate income U. S. workers with an adequate retirement income.

Tax Subsidies for Voluntary Savings Do Not Make Sense from Either a Tax Policy or a Retirement Income Policy Perspective

Finally, it is important to emphasize that we are not saying that voluntary savings are not an important aspect of retirement income policy. They have always been the "third leg" of the retirement income "stool" — the "whipped cream" on the retirement income "cake." They provide the only means for most upper and upper middle income employees to maintain their standard of living in retirement. These employees have always saved for retirement and will continue to do so with or without assistance from the government.

The issue before Congress should not be whether one kind of voluntary saving is better than another but whether tax preferences for voluntary savings make sense at a time of acute federal deficits. The IRA experience has demonstrated conclusively that tax incentives for voluntary savings provide almost no retirement income at lower income levels. This is as true of payroll deduction IRAs as others. The retirement income benefits of 401(k) plans promise to be equally illusory.

Like IRAs, they are extraordinarily popular with employees looking for a tax shelter; but also, like IRAs, they are of no benefit to employees who have no money to save and no need for tax breaks. Popularity should not be determinative of an issue of such far-reaching consequences both to current taxpayers and future retirees. This is one instance whether sound tax policy also represents sound retirement income policy.

Thank you. I would be pleased to answer any questions you may have.

Senator NICKLES. Thank you very much, Ms. Ferguson.

I have a couple of questions for you on 401(k). You are in favor of terminating all 401(k)'s and basically make any type of a pension contribution aftertax dollars?

Ms. FERGUSON. Yes. Basically going back to where we were before the Internal Revenue Service's proposed 401(k) regulations.

Senator NICKLES. Do you favor IRA's?

Ms. FERGUSON. No. Although we don't oppose voluntary savings—that's always been an essential part of our retirement income policy—we do not favor tax subsidies for voluntary savings. We do not favor "Government intrusion" Government interference—in voluntary savings decisions.

We do not think there is a need for tax subsidies of voluntary savings. I think the history of this country has proved thate "do-it-yourself" retirement arrangements do not work. They do not work for those most in need of a supplement to Social Security.

Senator NICKLES. By "do-it-yourself," you're talking about private pension systems?

Ms. FERGUSON. No. "Do-it-yourself" retirement arrangements are a voluntary arrangement—IRA's or 401(k)'s—anything where the individual makes the decision to save.

The problem is a very commonsense problem, a very practical problem. Most people cannot afford, if they are at a moderate or low-income level, to save early enough or in large enough amounts for retirement. Retirement involves a great amount of money. The development over the years of the private pension system has been tremendously encouraging.

It is a cost-efficient way of encouraging employers.

Senator NICKLES. So the thrust of your private pension is you don't like anything with the employee having the individual option. You would want it to be blankets and everything to be used with aftertax dollars?

Ms. FERGUSON. In terms of voluntary savings, yes. If we have a budget deficit here and we have to decide how to allocate revenue losses, tax expenditures, then thrift plans were very, very heavily used. They had employer matches, they were payroll based. They were very popular and they were used for conventional savings.

They are a way, certainly, of saving for short-term needs and, to some extent, for older workers for retirement needs.

Senator NICKLES. To take that theory a little bit further, would you favor taxing all health and accident insurance premiums? We've talked about the bases and talked about the caps, but I think if I followed your theory all the way through that you would favor taxing all benefits whatsoever.

Is that correct?

Ms. FERGUSON. Consistent with our name, the Pension Rights Center, we do not get into health and insurance areas.

We support tax breaks, for employer-paid pension plans. I even think, at this point—recognizing the need that employers have for employees to share part of the burden—that we would probably support tax deferral for employee contributions to pension plans.

That is something that we are considering now.

Senator NICKLES. Are you saying you want employees to contribute to defined-benefit plans on a before-tax basis?

Ms. FERGUSON. We now have many plans that are contributory, where there is a mandatory contribution by employees and those employees do not get any tax break. That's aftertax dollars.

Senator NICKLES. They're after tax.

Ms. FERGUSON. Right.

Senator NICKLES. Do you favor reversing that?

Ms. FERGUSON. What I said was that we are considering it because there seems to be a real interest in something like this. Canada, of course, has always had this: that the employee deductions are tax deductible.

Senator NICKLES. Who has had that?

Ms. FERGUSON. I believe Canada—at least so we have been told—has had tax-deductible contributions.

Senator NICKLES. I'm not sure.

Ms. FERGUSON. I'll have to verify that.

The enthusiasm for 401(k)'s by employers has a number of different sources. One which may be a legitimate source—one that we are exploring—we are discussing—is: Is their attractiveness attributable to the fact that the employee is sharing the burden, in fact in some cases assuming the entire burden, for the savings?

Is that why they are so attractive to so many employers?

If so, then the direction to go is not in the direction of these new vehicles, which are not really retirement vehicles, but to consider the same factors—the sharing of the cost, if you will—within a framework that has been shown to work very efficiently for many people.

Senator NICKLES. I appreciate your comments.

Mr. Schaitberger, you mentioned a real concern—and I would say that I would share that concern—on an excise tax on a withdrawal prior to the age of, what, 59 or 59½?

Mr. SCHAITBERGER. That's correct.

Senator NICKLES. I wasn't aware until I read your statement, you were giving the example of this tax. Did you say that that, itself, would not be deductible?

Mr. SCHAITBERGER. That's correct.

Senator NICKLES. Taking your example, an individual would pay the 20-percent tax on that and then they would still have to pay income tax on the $15,000?

Mr. SCHAITBERGER. That's correct.

Senator NICKLES. Not the $15,000 minus the tax?

Mr. SCHAITBERGER. That's correct.

Senator NICKLES. That's absurd.

Mr. SCHAITBERGER. Well, yes. We didn't use that word in our statement, but that's an appropriate word.

This has been kind of a consistent theme over the last several years coming from the administration. I think that a decision has been made and there is a move afoot to force retirement age up.

Generally, they believe people should be retiring at later ages. There may be some justification for that—they point toward longevity—but there is certainly a certain class in professions, at least, in this country that not only deserve, but really require the ability to retire people in order to maintain the level of service on behalf of the citizenry.

That certainly would be lost if the disincentives to retiring at those ages are so strong that you force law enforcement officers, firefighters and the like to work well into their sixties.

Senator NICKLES. You mentioned also in your statement that the 415 limitations of 1982 would affect firefighters?

Mr. SCHAITBERGER. Yes.

Senator NICKLES. Do you have examples of that or could you provide them?

Mr. SCHAITBERGER. I can provide that. I will provide you with some not only general examples, but real live examples and the way that the actuarial table, in a practical sense, affects the public safety field.

Senator NICKLES. If you would, I would personally appreciate it and I think members of this committee would, as well, because we are still learning of the ramifications of some of the changes that were made in 1982 and, for that matter, in some of the other pension changes.

Mr. SCHAITBERGER. This was similar to the provision that was enacted which also inadvertently placed a restriction on the distribution of survivorship benefits to surviving dependents.

As you, I am sure, will recall, that inadvertently was the effect of section 235, I believe, and required the distribution to be made over a 5-year period. The practical consequences were individuals leaving young dependent children and those distributions would have to cease at the end of 5 years.

The Congress, in its wisdom, corrected that and we believe they need to do the same, now, with the 415.

Senator NICKLES. Thank you both for your participation before the committee.

On our next panel are Kathy Kucharski representing Parker Drilling Co.; Steve Koch, vice president and treasurer of the Peoria Journal-Star, Inc. and also John Naughton, who is executive vice president of Group Pensions, Massachusetts Mutual Life representing the American Counsel of Life Insurance.

Senator NICKLES. Kathy, would you be first?

Ms. KUCHARSKI. Yes; that's fine.

STATEMENTS OF KATHY J. KUCHARSKI, ESQ., REPRESENTING PARKER DRILLING CO., ACCOMPANIED BY WILLIAM E. MATTINGLY, ESQ.; STEVEN R. KOCH, VICE PRESIDENT AND TREASURER, PEORIA JOURNAL-STAR, INC.; AND JOHN M. NAUGHTON, EXECUTIVE VICE PRESIDENT, GROUP PENSIONS, MASSACHUSETTS MUTUAL LIFE, REPRESENTING THE AMERICAN COUNCIL OF LIFE INSURANCE

Ms. KUCHARSKI. I am Kathy Kucharski. I am in-house counsel for Parker Drilling Co. in Tulsa, OK. With me is Bill Mattingly. He is our outside counsel in the area of employee benefits. He is with the law firm of Katten, Muchin, Zavis, Pearl & Galler in Chicago, IL.

I will summarize briefly our statements, but ask that our full statement be preserved for the record.

Senator NICKLES. Certainly.

Ms. KUCHARSKI. We appreciate this opportunity to present the views of Parker and our employees on 401(k) plans to this distinguished subcommittee.

Parker Drilling Co. is a deep oil and gas drilling contractor with operations located throughout the United States and 14 other nations. It was founded in 1934 and its shares are traded on the New York Stock Exchange.

Parker specializes in deep drilling which is deeper than 15,000 feet and operates in remote and inaccessible areas from Papua, New Guinea, to the Arctic zones, from South American jungles to environmentally protected areas of the United States.

For 50 years, Parker has developed and maintained a solid reputation as an innovative leader in the drilling industry. However, throughout these years Parker has experienced turbulent times caused by the cyclical nature of the business.

Approximately 75 percent of the 2,900 persons presently employed by Parker are employees working out in the field on the drilling rigs. Due to the cyclical nature of our business, during the past 4 years our work force has ranged from a high of 7,100 employees to a low of 2,600 employees.

The typical Parker field employee is paid on an hourly basis, works 8 to 12 hours per day, averages 25 days per month, and usually moves with the drilling rig.

Due to the cyclical nature of the company's business, the typical defined-benefit pension plan does not meet the needs of the company or its employees. In times of downturn in the oil industry, such as we are now experiencing, many employees are laid off resulting in an interruption of benefits and the company is not financially in a position to carry the funding obligations associated with a defined-benefit plan.

Thus, the company, until 1979, had no qualified retirement plan for its employees. In 1980, we started a profit-sharing plan. Then, in 1984, the company added the 401(k) feature to this plan.

To encourage participation and to enhance retirement benefits, the company also added a company matching feature. The 401(k) feature has been enthusiastically received by the employees at Parker.

The Parker profit-sharing plan with the 401(k) feature works well as it fits the financial needs of the company and allows the employee to decide whether and how much the employee will contribute. No other benefit program offers so much flexibility as the 401(k) Program.

Were it not for the 401(k) feature, many of these employees would not have sufficient retirement savings even with an individual retirement account.

Parker believes the voluntary private pension system is the best system, that it works well and will continue to do so, but only if it left voluntary. One of the best methods of encouraging private industry to establish retirement programs is to provide flexibility in the design of those programs to meet the needs of that particular industry and its employees.

The President's tax proposals call for the elimination of the 401(k) plan. This would obviously restrict that flexibility and accordingly, in our opinion, does not encourage the continued growth of the voluntary private retirement system.

Specifically, in the case of Parker, it is the difference between a viable plan that works and no plan at all.

If tax expenditures for the private retirement system are too high, we believe it makes little sense to eliminate or restrict only one type of plan to lower those tax expenditures. This works a hardship on those employers, such as Parker, and their employees who utilize that type of program as their only retirement plan.

Thus, we believe that the revenue objectives being sought should not focus on the type of plan used to deliver the retirement benefit, but rather should focus on the cost of providing such benefit, perhaps as a percentage of payroll or a dollar amount of benefit per person per year.

Let private industry and its employees have the flexibility to fund retirement benefits within these limitations without regard to the nature of the plan used or whether more than one plan is used.

Thank you for this opportunity to present our views.

[The prepared statement of Ms. Kucharski follows:]

COMMENTS PRESENTED BY PARKER DRILLING COMPANY

TO THE

UNITED STATES SENATE

COMMITTEE ON LABOR AND HUMAN RESOURCES,

SUBCOMMITTEE ON LABOR

OCTOBER 1, 1985

We at Parker Drilling Company appreciate this opportunity to present our views on 401(k) plans to this distinguished subcommittee. Our presentation has been organized into four parts.

PART I

THE COMPANY AND ITS EMPLOYEES

Parker Drilling Company ("Parker" or "the Company") is a deep oil and gas drilling contractor with operations located throughout the United States and 14 other nations. Its shares are traded on the New York Stock Exchange.

Founded in 1934, the Company provides drilling services to major oil companies, independent oil and gas producers, governments and industrial end-users who develop their own energy sources.

Parker specializes in deep drilling (deeper than 15,000 feet) and operates in remote and inaccessible areas from Papua New Guinea to the Arctic zones, from South American jungles to environmentally protected areas of the United States.

The Company also provides specialized drilling crews for certain land rigs and offshore rigs, primarily in Alaska. Internationally, the Company specializes in both the difficult wells and the remote drilling.

For 50 years, Parker has developed and maintained a solid reputation as an innovative leader in the drilling industry. However, throughout these years Parker has experienced turbulent times caused by the cyclical nature of the business. For example, 1981 was an outstanding year in the Company's history during which revenue, net income and earnings per share reached new highs. Domestic activity was the strongest in the Company's history. International activity thrived. Throughout that year, Parker rigs averaged 95% to 100% utilization.

After experiencing the best year in its history, in 1982 the United States drilling boom was brought to an abrupt halt. In 1983 the Company reported its first loss ever and continues to suffer revenue losses due to the dramatic energy industry decline.

Approximately 75% of the 2,900 persons employed by Parker are employees working on a drilling rig. Not only are the drilling crews responsible for the 24-hour operation of a $4,000,000 drilling rig, but are also entrusted with maintaining good working relationships with our customers.

Due to the cyclical nature of our business, during the past four years our workforce has ranged from 7,100 to 2,600.

The typical Parker field employee is paid on an hourly basis, works 8-12 hours per day, 25 days per month, and usually moves with the drilling rig.

PART II

RETIREMENT PLAN HISTORY

Due to the cyclical nature of the Company's business, the typical defined benefit pension plan does not meet the needs of the Company or its employees. In times of downturn in the oil industry, such as we are now experiencing, many employees are laid off resulting in an interruption of benefits and the Company is not financially in a position to carry the funding obligations associated with a defined benefit plan. Thus, the Company until 1979 had no qualified retirement plan for its employees.

In 1979, the Company adopted a tax reduction act employee stock ownership plan (TRASOP). Due to the Economic Recovery Tax Act of 1981, this plan was terminated as an ongoing plan.

In 1980, due to the Company's profitability, a profit sharing plan was adopted by the Company. However, the Company has not recently made any profit sharing contributions to the plan due to its depressed economic condition.

In 1984, the Company amended the profit sharing plan to add a 401(k) feature. To encourage participation and to enhance retirement benefits, the Company also added a company matching feature. The 401(k) feature has been enthusiastically received by the employees at Parker. At present, approximately 47% of all eligible employees are participating in the 401(k) plan.

The Parker profit sharing plan with the 401(k) feature works well, as it fits the financial needs of the Company and allows the employee to decide whether and how much the employee will contribute. No other benefit program offers so much flexibility as the 401(k) program. A simplified employee pension plan does not give the employee any choice. In addition, the employees of Parker receive the benefit of having their contributions invested at their direction in one or more of four investment options, payroll deduction, a company match and having their accounts maintained by professional recordkeepers. Were it not for the 401(k) feature, many of these employees would not have sufficient retirement savings even with an individual retirement account.

PART III

THE VOLUNTARY NATURE OF THE PRIVATE PENSION SYSTEM

This country's private pension system is a voluntary system designed to supplement personal savings and social retirement programs. It has served this country well in providing for the retirement needs of its elderly and it continues to grow and cover more and more people.

Parker believes the voluntary, private pension system is the best system, that it works well and will continue to do so, but only if it is left voluntary. Thus, we believe that, within the limits of a sound fiscal and retirement policy for this country, every effort should be made by Congress to encourage private industry to offer retirement programs to its employees rather than discourage the establishment of such programs. One of the best methods of encouraging private industry to establish retirement programs is to provide flexibility in the design of those programs to meet the needs of that industry and its employees. At this time, that flexibility is provided by the variety of qualified plans available through the Internal Revenue Code of 1984, as amended, ("Code") ranging from a 401(k) plan (which is voluntary to the employer and employee and based upon profits), to the mandatory defined benefit pension plan (which is voluntary to the employer and may be voluntary to the employee but is not based upon profits). The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity, dated May 29, 1985, as amended, (the "President's Proposal") calls for the elimination of the 401(k) plan. This would obviously restrict that flexibility; and accordingly, in our opinion, does not encourage the continued growth of the voluntary, private retirement system but rather will retard the system. Specifically, in the case of Parker, it is the difference between a viable plan that works and no plan at all.

PART IV

FISCAL AND RETIREMENT POLICY

Parker endorses the Administration's efforts and the efforts of this Congress to control and reduce the federal deficit through spending cuts and the reduction of tax expenditures. However, Parker believes that the revenue needs of this federal government should be balanced, and if necessary, checked by the appropriate retirement policies for this country. As we have already discussed, Parker endorses a voluntary, private retirement system which provides the maximum flexibility to both the employer and the employee in the design and use of a retirement program. Thus, we believe that the revenue objectives being sought should not focus on the type of plan used to deliver the retirement benefit, but rather (1) on the cost of providing such benefit as a percentage of payroll, (2) a dollar amount per person per year, or (3) the amount of such benefit at retirement available to each person expressed as the lesser of some dollar amount or as a percentage of that person's earnings.

If tax expenditures for the private retirement system are too high in the opinion of this Congress and the Administration, it makes little sense to kill or restrict only one type of plan to lower those tax expenditures. This works a hardship on those employers (such as Parker) and their employees who utilize that type of program as their only retirement plan. For many employees a 401(k) plan is a supplement to an otherwise adequate defined benefit pension plan. It makes little sense to us to take the 401(k) plan away both from these persons (where the benefit is supplemental) and from a Parker employee (where the benefit is nonsupplemental). Since one of the fundamental goals of a good retirement policy is to broaden the coverage of the private pension system to as many people as possible, it is consistent with that goal to reduce the benefits provided to some so that more people may be covered.

Lastly, we believe that the elimination of the 401(k) feature as a revenue raising source results in employers having only a 401(k) plan, such as Parker, sacrificing a greater proportion of their retirement budget than other employers who have multiple types of plans. For example, the tax expenditure for providing retirement benefits at Parker for fiscal year 1985 was approximately 5.1% of eligible payroll compared to the 1984 national average of 12.4%.[1] If 401(k) plans are eliminated as recommended by the President's

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[1] Report to Participants on Large Pension Plans 1985, Greenwich Research Associates (1985).

Proposal, Parker's retirement plan tax expenditure as a percentage of payroll will be reduced 73%, whereas employers with both a defined benefit plan and a defined contribution plan (including a 401(k) feature) will have only a 39.5% reduction.

Ironically, our global approach to developing a sound retirement policy has been incorporated, in part, in the President's Proposal to eliminate the combination limits of Code Section 415 as applied to a single employer and to focus on the amount of retirement benefit payable to any single person from all employers. We believe that this makes for a sound retirement policy. Let private industry and its employees have the flexibility to fund retirement benefits within the limitation of this policy without regard to the nature of the plan used or whether more than one plan is used.

Senator NICKLES. We thank you very much.

Mr. Koch.

Mr. KOCH. Thank you, Mr. Chairman.

I would appreciate it very much if my written statement could be entered into the record.

I am Steve Koch, vice president and treasurer of the Peoria Journal-Star. We publish the largest daily newspaper in Illinois outside of Cook County. We also publish five national magazines and operate seven radio stations.

We have an employee stock ownership plan for the benefit of all of our employees. Our plan is structured in such a way that it provides that the employee group will own 100 percent of our company by 1993.

A section 401(k) arrangement is part of our ESOP enabling employees to contribute a portion of their salaries and receive a dollar-for-dollar match from the company. Half of our annual contributions to the ESOP result from the 401(k).

The proposal of the administration to repeal section 401(k) would be a disaster for our company and our employees. Accordingly, I appreciate this opportunity to place our concerns before you.

By way of background, Peoria Journal-Star has been closely held and locally owned for the past 100 years. We are one of the few major dailies which remain independent of a national newspaper chain.

Our shareholders have had many opportunities to sell to the chains at very attractive prices. They have opted not to do so because of their strong belief that ownership of the newspaper should remain local and ultimately rest in the hands of its employees.

Therefore, to ensure local employee ownership we established our ESOP in 1983 and the existing shareholders have contractually agreed to sell 100 percent of the business to the employees over a 10-year period. We are only a little more than 7 years away from achieving our goal.

The success of our plan hinges on the continuation of the 401(k) feature where each employee can contribute a portion of his or her salary and receive a dollar-for-dollar match from the company up to 5 percent of compensation.

The 401(k) also provides, in our case, another important benefit. To the extent the ESOP improves employee morale and productivity—and we believe experience shows this to be the case—the 401(k) is essential because an employee who has voluntarily placed his funds at risk in the business has a far greater stake in its success.

Over 80 percent of our employees participate in the 401(k). They have been very well rewarded to date for their participation.

As of March 1985, the average employee's ESOP account contained $25,599 worth of Peoria Journal-Star stock. The appraised value of that stock increased by 25 percent in 1984 compared with a 6.2-percent increase in the Standard & Poor's 500 last year.

In 1983, our employees owned no stock of the Peoria Journal-Star. As of March 1985, our 455 employees owned 25 percent of the business. This stake will increase to 100 percent by 1993 unless revisions to the Tax Code make it impossible for us to continue our plan.

The expectation that we could achieve 100 percent ownership by the employees was critical to the existing shareholders' decision to sell to the ESOP rather than to a national newspaper chain. The employees have also been investing their funds over the past 3 years based on the expectation they would own 100 percent of the company by 1993.

Unfortunately, the President's proposal would defeat the legitimate expectations of all parties by radically changing the law. If the President's proposal were applied to our ESOP, the employee ownership interest would effectively be frozen at its 25 percent minority position: an untenable position desired by no one and beneficial to no one.

The employees have been making their contributions over the past 2 years in reliance on existing law in expectation they would obtain full control of the company by 1993. Even if the ESOP could somehow be continued without the benefit of the section 401(k), the rate at which the ESOP could obtain company stock would be so greatly slowed that many years would pass before the employees could rise above a minority position in the corporation.

To summarize, the section 401(k) arrangement of the Peoria Journal-Star is unlike many such arrangements in that it is more than just a means of saving for retirement. It was created with the specific purpose of transferring full ownership of our enterprise to its employees.

That goal is not a distant one. Under present law, it will be achieved in a little over 7 years.

To deprive the ESOP of the section 401(k) benefit would leave the plan stranded in a status no one intended with the employee group frozen in to a minority position in the company. It would work a grave injustice on people who made economic decisions in complete and reasonable reliance on the tax and retirement laws of the country.

We oppose repeal of section 401(k), Senator. If, however, section 401(k) is generally repealed, that repeal must not be allowed to affect ESOP plans like the Peoria Journal-Star

We are in the midst of a coherent plan to achieve 100 percent employee stock ownership. It makes no sense to stop us in midstream when we have just a few more years to achieve our goal.

Section 401(k) must remain available to plans such as ours for the remaining brief period of time required for the plan to achieve its original purpose.

Thank you very much.

[The prepared statement of Mr. Koch follows:]

TESTIMONY
PRESENTED
TO THE
UNITED STATES SENATE
SUBCOMMITTEE ON LABOR
COMMITTEE ON LABOR & HUMAN RESOURCES

TUESDAY, OCTOBER 1, 1985

BY STEVEN R. KOCH
VICE PRESIDENT/TREASURER
THE PEORIA JOURNAL STAR, INC.
ONE NEWS PLAZA
PEORIA, ILLINOIS 61643
(309) 686-3144

TESTIMONY

Mr. Chairman, Members on the Subcommittee on Labor:

I am Vice President and Treasurer of The Peoria Journal Star. We publish the largest daily newspaper in Illinois outside Cook County, as well as five national monthly magazines. We also operate seven radio stations. For the past two years, we have maintained an employee stock ownership plan -- an ESOP -- for the benefit of our employees. A section 401(k) arrangement is part of the ESOP, enabling employees to contribute a portion of their salaries to the ESOP and to have their contributions matched by the Company. The proposal of the Administration to repeal section 401(k) would be a disaster for our Company and our employees, as it would produce a situation which would serve no one's interest and would make no sense as a matter of public policy. Accordingly, I appreciate this opportunity to place our concerns before you.

By way of background, The Peoria Journal Star has historically been closely-held and locally-owned. We are one of the few major daily newspapers which remain independent of a national chain. The chains are quite anxious to acquire newspapers such as ours, and our shareholders have been presented with many opportunities to sell their shares at very attractive prices. The family which has owned The

Peoria Journal Star has, however, foregone such opportunities because of a strong belief that ownership of the newspaper should remain local and should ultimately rest with the employees of the newspaper.

Therefore, in order to ensure local, employee ownership, we established our ESOP in 1983, and the existing shareholders entered into a "Put and Call Agreement" giving the ESOP the right to acquire shares from them over a ten-year period ending in 1993. Our goal was and is to achieve 100% employee ownership as quickly as we can do so in a practical, orderly manner. The section 401(k) arrangement is essential if we are to attain our goal. Under that arrangement, each employee may contribute a portion of his salary to the ESOP, and the Company matches that contribution on a dollar-for-dollar basis up to 5% of salary.

The success of the ESOP hinges on the section 401(k) arrangement. By substantially diminishing the time required in order for employees to obtain control of the Company, the section 401(k) arrangement makes the goal of control vastly more tangible for the employees. To the extent that the objective of the ESOP is to improve employee morale and productivity, the section 401(k) arrangement is essential because an employee who has voluntarily placed his own funds at risk in the business has a far greater stake in its success than one who has not. To the extent that the goal of the ESOP is to encourage saving by employees, the section 401(k) arrangement with its matching feature is a very powerful device indeed.

Over 80% of our eligible employees participate in the section 401(k) arrangement. The average employee contributes over 4% of his annual salary to the ESOP. In light of the numerous articles bemoaning the very low rate at which the American public saves -- a rate which fell to a twenty-six year low of 2.8% in August -- the fact that our employees are willing to contribute more than 4% of salary to the ESOP is significant indeed. I might add that our employees have been well rewarded economically for their investments in the ESOP. As of March 1985, the average employee account contained $25,599 worth of stock in The Peoria Journal Star. The appraised value per share of that stock increased by 25% during 1984, as compared with a 6.2% increase in the Standard & Poor's 500.

In 1983, our employees owned no stock of The Peoria Journal Star. As of March 1985, our 455 employees owned 25% of the business through their ESOP accounts. It is our intent and expectation that by 1993 -- ten years after the ESOP began -- our employees will own 100% of the Company's stock by virtue of the ESOP.

The expectation that the ESOP will produce complete employee ownership of the Company within a very few years was critical to the Company's decision to establish and fund the ESOP, to the agreement by the existing shareholders to sell their stock to the ESOP rather than to a national newspaper chain, and to the decisions by the employees to place a portion of their own income in the ESOP. That expectation, upon which all parties have relied, is solidly based on existing law and will almost certainly be realized if existing law is not fundamentally altered.

Unfortunately, the President's proposal would defeat the legitimate expectations of all parties by radically changing the law. While the proposal contains language supporting employee stock ownership, the provisions relating to ESOPs would make it impossible, as a practical matter, for employers to maintain such plans. The elimination of section 401(k) would make employee contributions under our plan a thing of the past.

If the President's proposal were applied to the ESOP maintained by The Peoria Journal Star, the ESOP would be frozen at its present level of owning 25% of the corporate stock. This would be an untenable situation, desired by no one and beneficial to no one. The employees, who have over the past two years made substantial contributions to the ESOP in reliance on existing law, would be frustrated in their desire to obtain full control of the Company. They would instead be frozen as minority shareholders in a corporation in which 75% of the stock is closely-held. Even if the Company were legally able and willing to continue the ESOP without the benefit of a section 401(k) arrangement, the rate at which the ESOP could acquire company stock would be so greatly slowed that many years would pass before employees could rise above minority status in the corporation. It is unlikely that employees would be much interested in the ESOP under these circumstances.

Furthermore, it is improbable that the Company would be willing to maintain the ESOP if section 401(k) were eliminated. An important purpose of an ESOP is to provide employees with a stake in the business. It is well recognized that employees who have voluntarily contributed their own funds to purchase employer stock have a far greater incentive than those who have made no such contribution. The elimination of section 401(k) would severely diminish the effectiveness of the ESOP in motivating employees.

To summarize, the section 401(k) arrangement of The Peoria Journal Star is unlike many such arrangements in that it is more than just a means of saving for retirement. It was created with the specific purpose of transferring full ownership of the Company to its employees. That goal is not a distant one; the ESOP will, under present law, achieve that goal in less than ten more years. To deprive our ESOP of the benefits of section 401(k) would be to freeze the plan at 25% stock ownership. It would leave the plan stranded in a status which no one intended and which makes sense for no one. It would work a grave injustice on people who made economic decisions in complete and reasonable reliance on the tax and retirement laws of this country.

We oppose repeal of section 401(k). If, however, section 401(k) is generally repealed, that repeal must not be allowed to affect employee stock ownership plans like that of The Peoria Journal Star. We are in the midst of a coherent plan for achieving 100% employee stock ownership. It makes no sense to stop us in mid-stream, particularly when we are within just a few years of achieving our goal.
Section 401(k), even if generally repealed, must remain available to plans such as ours for the relatively brief period of time required for the plan to achieve its purpose and thereby satisfy the legitimate expectations and desires of its creators and participants.

Thank you.

Respectfully submitted,

Steven R. Koch

Senator NICKLES. Mr. Koch, thank you very much.

Mr. Naughton.

Mr. NAUGHTON. Mr. Chairman, I am John Naughton, chairman of The American Council of Life Insurance Pension Committee and executive vice president of the Massachusetts Mutual Life Insurance Co. The ACLI is the major trade association representing the life insurance industry.

It's a pleasure to appear today before the subcommittee to speak on the retirement policy implications of the administration's tax reform proposal. At the outset, I want to commend the subcommittee for having undertaken a review of this important subject and for holding this hearing.

Our written statement details our objections to many of the administration's proposals affecting qualified employee benefit plans. Therefore, my remarks will focus on only two issues: the need for a national policy on retirement income, and the administration's proposals relative to section 401(k) plans.

The administration's tax reform proposal would have a severe adverse impact on qualified retirement plans and the role they play in meeting our Nation's retirement income needs.

When retirement issues are considered as part of tax reform, tax revenue rather than retirement security becomes the overriding consideration. We submit that this is an inappropriate way to deal with rules for retirement plans.

The ACLI supports a national retirement policy that has three basic objectives: One, to strengthen the private pension system; two, to encourage greater personal savings for retirement; and three, to ensure the fiscal soundness of the Social Security System.

The council's belief is that the strength of our private system lies in its flexibility. The basic themes characterizing the private pension system have been voluntary choices by employers subject to reasonable nondiscrimination rules, protection of core benefits, and flexibility for employees and employers in tailoring retirement and benefit programs.

Any changes in national retirement policy need careful consideration, and we have serious doubts that the proposed tax bill will provide that opportunity.

We strongly suggest eliminating the employee benefit provisions from the administration's tax reform proposal. Any significant changes affecting employee benefits should be separate legislation enacted after careful consideration by the Labor and Tax Committees of Congress.

Unfortunately, we have no choice but to address national retirement income policy in the context of a revenue bill. In this regard, I would like to direct your attention to section 401(k) plans and to emphatically state that these plans are essential to the future of adequate retirements savings.

Under section 401(k) plans, employees may elect to defer receipt of cash compensation and the employee is not currently taxed on deferred amounts; but you should note that the employee does not escape taxation: all amounts are taxed in full when distributed by the plan.

During the past 3 years, section 401(k) plans have grown faster than any other employee benefit ever introduced. The number of individuals participating in these plans tripled between 1983 and 1984.

Estimates are that 19 million employees are currently eligible to participate in section 401(k) plans, and these plans may now cover 28 percent of the private sector work force. In addition, participation rates in section 401(k) plans are high: more than 60 percent of eligible employees were participating in section 401(k) plans at the end of last year.

The May 1985 administration proposal did not advocate the repeal of section 401(k) plans. Instead, the May proposal would have modified the current plan rules.

However, on August 31 the Treasury Department proposed to repeal these plans solely to gain additional revenue. In light of the wide acceptance and enthusiasm for section 401(k) plans, we respectfully submit that these retirement plans should not be repealed nor substantially changed.

We think the administration proposal harbors a number of serious misconceptions about section 401(k) plans. For example, all qualified retirement plans including section 401(k) plans must comply with general nondiscrimination rules.

In addition to these general nondiscrimination rules, section 401(k) plans are also subject to special more rigorous nondiscrimination tests. These tests ensure that the highly-paid employees do not benefit disproportionately. Nevertheless, the administration (as well as the Ways and Means option) would impose were more stringent rules that most 401(k) plans would have difficulty meeting.

Section 401(k) plans are not tax shelters for the highly-paid, whereas IRA's—including spousal IRA's—are largely enjoyed by the affluent. For every age and every earnings group, section 401(k) participation exceeds IRA participation rates. More importantly, section 401(k) plans are utilized by significantly more lower-income employees than IRA's.

It is also important to understand that contributions to IRAs have largely been a shifting of funds from one savings vehicle to another, whereas section 401(k) plans provide new savings and thus increase the pool of long-term capital for national economic growth.

It appears the administration does not recognize that eliminating hardship distributions will reduce the level of retirement savings among low- and middle-income employees. This safety valve of limited accessibility of funds for hardship has encouraged millions of employees to defer current compensation in favor of providing for retirement security.

Yet, in practice, an average of only 1.3 percent of section 401(k) participants make withdrawals; and I agree with your comments that the proposed changes in the lump-sum distribution rules are ill-conceived.

This is a very popular option and one that largely benefits the lower and middle income employees.

Finally, the elimination or substantial modification of section 401(k) plans will limit the ability of many employers to offer an adequate retirement program or any retirement program at all to their work forces. At a time when one of the most serious national retirement policy problems has been the encouragement of retirement plan coverage across all industries, section 401(k) plans have emerged as a large part of the solution.

Let's not fall into the trap of eliminating the best available vehicle for expanding coverage to low- and middle-income workers in order to raise additional revenue.

In summary, questions of national policy for employee retirement savings should be considered as separate legislation outside the tax forum.

I appreciate this opportunity to appear before you and share with you the views of the ACLI. I would be pleased to answer any questions you may have.

[The prepared statement of Mr. Naughton follows:]

STATEMENT OF
THE AMERICAN COUNCIL OF LIFE INSURANCE

on
The Pension Policy Implications
of the President's Tax Reform Proposals on
Benefit Programs and Retirement Savings

Before the Labor Subcommittee
of the Labor and Human Resources Committee
of the United States Senate

October 1, 1985

Presented by

John M. Naughton, Executive Vice President
Massachusetts Mutual Life Insurance Company

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

My name is John M. Naughton. I am Executive Vice President, Group Pensions, at Massachusetts Mutual Life Insurance Company. I am speaking to you this morning on behalf of the American Council of Life Insurance ("ACLI"). The ACLI is a trade association with a membership of 627 life insurance companies. In the aggregate these companies account for approximately 95 percent of the life insurance in force in the United States and hold 97 percent of the assets of insured pension plans.

Mr. Chairman, you and the members of this Subcommittee are to be commended for these timely hearings on an issue of extreme importance to employees, employers, the government and our industry -- the pension policy implications of the President's tax proposals on benefit programs and retirement savings. Years ago, Congress recognized the need to place primary reliance on private sector sources to assure the adequacy of retirement income. As a result, it developed tax policies which encouraged employers and employees to use employee benefits to supplement the economic protection offered by public programs such as

Social Security. Since then, America has gone on to build an employee benefits system that is the envy of the world, and we are extremely proud to be part of this system.

Now some people are suggesting that we abandon these tax incentives in favor of tax neutrality and simplification. Others, citing growing deficits, would sacrifice these incentives for the added tax revenues. Irrespective of the reason, the proposed change in tax policy is short-sighted and wrong. It is wrong socially, wrong economically and wrong for the welfare of our nation. It is short-sighted in that it ignores the success of past achievements and shuts its eyes to the very real needs of the future.

All evidence indicates the need for expansion -- not contraction -- of privately provided employee benefits. Without a supportive federal policy in this area how will our nation be able to prevent a retirement disaster in the early twenty-first century as the "baby boom" generation enters retirement age?

The nation's retirement system works. There may be a need for improvements and some fine tuning, but overall the joint venture between plan sponsors and government has resulted in ever increasing economic security for the majority of American workers.

Workers at all compensation levels are accruing benefit credits and earning vested rights. The continuing operation of over 800,000 employer-sponsored pension plans and the prospect of over two thirds of today's workers receiving benefits upon retirement indicates that the public policy objectives of ERISA generally are met. And contrary to critics' allegations that the private pension system favors principally high income groups, analysis has shown that the majority of the benefits are enjoyed by the middle class.

Data and analysis of tax burdens and tax benefits show that the pension system is equitable. Those earning between $20,000 and $50,000 per year paid 51.1 percent of all individual income taxes and received 56.6 percent of the pension tax benefit in 1982. Taxpayers earning less than $20,000 per year paid 16 percent of individual income taxes and received 17.4 percent of the pension tax benefit.

With regard to capital formation, pension funds currently play a major role in U.S. capital and credit markets. In 1984 alone, pension funds provided over $90 billion to these markets -- about 12 percent of the total. While such investments are not the principal aim of pension plans, they play a vital role in our economy.

The impressive results noted above have been made possible by careful Congressional policy decisions to place primary reliance on private sector sources to assure adequacy of retirement income.

Now, in the name of tax reform and tax simplification, the Administration proposes changes to the private retirement system which endanger the very significant achievements of the system in providing financial protection for millions of American workers and their families. In particular, under the Administration's tax reform proposals:

A. Popular 401(k) retirement programs would either be repealed or severely restricted;

B. The special 10-year averaging provision for certain lump sum distributions from pension plans would be repealed;

C. New complex non-discrimination tests would be applied to various employee benefits -- including welfare benefit plans; and

D. A myriad of changes would be made with regard to retirement plans, including significant cutbacks in the treatment of Section 403(b) annuities.

To support its recommendations to make these drastic changes, the Administration argues that, if these recommendations were enacted, the tax laws could be simplified and tax rates could be reduced. In fact, the Administration's proposals relating to employee benefits are not simple and will result in increased taxes on participants in plans which provide important financial security. These changes could completely reverse long-standing policies to encourage the growth of private retirement and welfare benefits. Such changes would ultimately lead to less private coverage and would undoubtedly result in a demand for increased federal expenditures to take up resultant slack in these areas.

Most taxpayers oppose changes in the tax system that would tend to undermine their economic security -- a view clearly confirmed by public opinion surveys we commissioned earlier this year. A survey conducted by the Roper Organization revealed that both the general public and chief executive officers of major corporations are overwhelmingly against taxing employee benefits. In fact, more people think we should consider raising income taxes than think we should consider taxing employee benefits.

The balance of our statement will detail each of the Administration's proposals on employee benefits and the reasons why we believe each will have an adverse impact on the private retirement system.

A. PROPOSAL TO EITHER REPEAL OR SEVERELY RESTRICT SECTION 401(k) PLANS

Section 401(k) plans, also called "CODA's" (cash-or-deferred arrangements), were first permitted by the Revenue Act of 1978. Since 1982, these plans have rapidly become an important element in retirement savings and are, perhaps, the most popular benefit available judging from the number of plans being implemented. The Employee Benefit Research Institute (EBRI) reports that 4.8 million private sector employees were offered 401(k) plans in 1983. EBRI estimates further that approximately 19 million employees are currently eligible to participate in 401(k) plans. A 1985 survey sponsored by the Employers Council for Flexible Compensation suggests that 401(k) plans may now cover 28 percent of the private sector work force.

401(k) plans are employer-sponsored programs that permit employees to defer current compensation to meet future financial needs. In many cases, employers make discretionary contributions to match those made by employees. Under present law rules, amounts contributed to the plan are not includible in the employee's gross income at the time of contribution, provided that both normal qualification rules and a special set of requirements are met.

The Administration's original proposal, which was sent to the Congress in May 1985, would have modified elective contribution limits, non-discrimination tests, distribution rules and employer matching contribution provisions applying to CODA's. Recently, Treasury Secretary Baker sent a letter (dated August 31, 1985) to the Chairman of the House Ways and Means Committee suggesting the outright repeal of Section 401(k) in order to make the Administration's tax reform package more revenue neutral. We oppose the Administration's proposals to either repeal or severely strict Section 401(k) plans.

Why the Proposal to Repeal Section 401(k) Plans Should be Rejected

1. Section 401(k) plans provide employees with an attractive savings alternative for retirement.

In addition to proposing the repeal of Section 401(k) plans, the Administration is also proposing to increase the limits on contributions to IRA's. The Administration is thus selecting IRA's as the appropriate vehicle for the receipt of deductible retirement plan contributions by individuals to the exclusion of their existing plans. This would be a serious mistake and short sighted tax policy. The use of effective group arrangements, such as Section 401(k) plans, for the provision of retirement benefits should also be encouraged and should coexist with IRA's.

Section 401(k) plans have proven to be a very effective vehicle for expanding retirement income protection at middle- to low-income ranges. A 1983 study by Hewitt Associates demonstrated that IRA's, by contrast, are not an effective vehicle in this regard. According to that study, only 16.9 percent of the work force had established IRA's and that usage was highest among the higher paid employees. Only 11 percent of workers earning less than $20,000 established IRA's compared with 58 percent of those earning more than $50,000.

Contrasting these participation rates with 401(k) plan usage, two recent surveys, one by Hewitt Associates and a second by Towers, Perrin, Forster & Crosby, report that 60 and 63 percent, respectively, of eligible employees were participating in 401(k) plans at the end of 1984. As to distribution of 401(k) plan usage by income level, Census Bureau data tabulated for 1982-3 indicate that low-income workers, earning between $5,000 and $10,000, were three times more likely to participate in a 401(k) plan than in an IRA. Middle-income workers, earning up to $29,999, preferred 401(k) plans over IRA's two to one.

2. Section 401(k) plans distribute pension benefits across income classes and must meet very strict non-discrimination requirements. These plans are subject to audit to assure that all requirements are observed.

401(k) plans must satisfy special and rigorous non-discriminatory requirements. The special 401(k) rules prohibit discrimination in favor of "highly compensated employees" with regard to deferred amounts. Highly compensated employees may not contribute more than an allowable percentage of their compensation to a 401(k) plan. This percentage is directly influenced by the extent of participation in the plan by rank and file employees. These plans are subject to audit to assure that all requirements are observed. It is, therefore, in the interest of the highly compensated employees for the employer to encourage and sustain broad and meaningful plan participation on the part of rank and file employees.

The amounts involved under Section 401(k) plans do not escape tax. Taxes are simply deferred until the employee retires and receives the income. The Employee Benefit Research Institute has found that 72% of the tax deferred by active employees is eventually repaid in retirement.

3. Employer-sponsored plans are a sound and cost effective way to provide for retirement.

The "Final Report by the President's Commission on Pension Policy," 1981, recognized that "a major objective of retirement income policy should be to insure that today's retirees and tomorrow's elderly are able to maintain a reasonable standard of living in their later years." In view of this, the President's Commission recommended the expansion of the role of employer-provided deferred compensation plans.

To the extent the retirement needs of employees can be met by employer-sponsored qualified plans, it will not be necessary for the government to provide additional aid to retirees.

4. Employer-sponsored retirement plans encourage capital formation.

Private savings and capital formation should be encouraged. One way this goal can be achieved more effectively by Congress is through encouragement of broad-based retirement plans maintained by employers to provide income security for great numbers of employees. Capital formation achieved through employer-sponsored plans will benefit the economy while at the same time employees will obtain the benefit of participation in employee benefit plans such as Section 401(k) plans.

For the reasons set forth above, the current tax provisions authorizing Section 401(k) plans should be continued.

Why the Proposal to Severely Restrict Section 401(k) Plans Should be Rejected

The Administration's initial May 28 proposal would limit an employee's contribution to a 401(k) plan to an unindexed $8,000 less any IRA contribution. The current "ADP" (Actual Deferral Percentage test, i.e., the formula for determining allowable contributions based on non-discrimination standards) would be modified in three ways: the definition of the prohibited group would be altered; the allowed difference between contributions made by members of the prohibited and non-prohibited groups would be reduced; and the test would be applied to the individual deferral ratios rather than the aggregate ADP for the prohibited group. Distributions of elective contributions would be allowed only at death, disability, separation from service or plan termination; currently distributions may also be made in hardship situations. Employer matching contributions would be subject to the same ADP test as employee elective contributions, and under some conditions to a more severe ADP test.

While all tax-favored retirement plans, including profit-sharing plans, would be subject to a strict non-discriminatory coverage test, a different eligibility test would apply to CODA's. The fraction of the prohibited group members eligible to make elective contributions could not exceed 125% of the analogous ratio of other employees.

Finally, CODA's could no longer be maintained by exempt organizations and governmental units on a tax-qualified basis.

1. CODA's are more like other qualified employer-sponsored retirement plans than they are like IRA's. It is therefore inappropriate to impose additional IRA-type limits on the contributions.

CODA's are qualified employer-sponsored retirement plans. An elective contribution under a CODA has the same tax effect for the employee as a deductible contribution by the employer to any other qualified employer-sponsored defined contribution plan, such as a traditional profit-sharing plan or a money purchase pension plan. Furthermore, CODA's must meet strict contribution and distribution rules, anti-discrimination and eligibility requirements, coverage tests, participant loan rules and employer deduction rules. Importantly, under the Administration's proposal, the anti-discrimination tests for CODA's are significantly more rigorous than the general anti-discrimination rules applicable to all other qualified employer-sponsored retirement plans.

Any tax reform proposal should provide similar tax advantages to, and impose similar restrictions on, employees of employers maintaining CODA's as apply to alternative qualified employer-sponsored retirement plans. Thus, an employee's elective contributions to a CODA should be subject to the aggregate contribution limits applicable to "annual additions" to an employee's account under all other qualified employer-sponsored defined contribution plans. (Current "annual additions" to an employee's account or accounts may not exceed the lesser of: (a) 25% of the employee's compensation, or (b) $30,000. See IRC Section 415.) The possibility of the employee making an IRA contribution in any particular year does not affect the defined contribution limit and should not affect the employee's contributions to a CODA.

The reasons for the tax-favored treatment of qualified employer-sponsored retirement plans and the accompanying limitations on these plans are very different from the reasons for IRA's. The tax benefits applicable to IRA's are intended to encourage individuals to save on their own initiative for retirement. The broad and consistent availability of IRA's for individual retirement savings should, of course, be encouraged. On the other hand, qualified employer-sponsored retirement plans have long been recognized as a broad-based, non-discriminatory way of providing for the retirement of a great number of employees, many of whom would not save for retirement absent the employer's plan. Cash or deferred arrangements have been an optional qualified employer-sponsored retirement plan since 1956 and since 1980 have rapidly become an important primary or supplemental employer/employee retirement plan. It is illogical to single out one type of employer- sponsored retirement plan, the CODA, and subject this plan to both an arbitrary dollar limit and integration with individual retirement savings options. Therefore, CODA's should be given parity with other profit-sharing plans when setting contribution limits.

2. The IRA integration requirement will generate severe administrative problems and associated expenses for 401(k) plan sponsors and confusion for participants.

Sponsors of 401(k) plans naturally have no information on the extent to which the employees are participating in and contributing to IRA's. Although, in principle, the employees will have to monitor their contributions to both arrangements and deal with any excess contributions, in practice much of the burden will fall on the 401(k) plan administrator.

Employees who receive raises after having made IRA contributions will request projections of their 401(k) contributions and modifications of their deferral ratios. Employees who miscalculate their allowable contributions will at year-end, or even in the following year, seek to retrieve contributions or to reallocate deferred to non-deferred contributions. Employers will have to establish elaborate administrative rules and procedures. Employees will be confused and disgruntled and participation will be adversely affected.

3. The $8,000 contribution limit would significantly disadvantage employees in businesses which cannot afford an additional retirement plan.

In 1981, the President's Commission on Pension Policy identified coverage as one of the key problems of private sector plans. It was concerned that only half of the work force was covered under retirement plans. In many instances, CODA's are established by employers who could not otherwise afford to sponsor a qualified retirement plan for their work forces. A nationwide survey, commissioned by the Employers Council on Flexible Compensation, indicated that almost a half-million small businesses offer 401(k) plans to their employees. For 37% of those businesses, the 401(k) plan is the only retirement program.

The popularity of CODA's is due, in part, to their value as a lower-cost employer-sponsored retirement plan. Through salary reduction, employees are able to maximize the value of their retirement savings beyond those amounts, if any, which the employer could afford to contribute on their behalf under a more traditional arrangement, or which they would receive directly in a plan where there were only non-deductible employee contributions. A contribution limit as restrictive as the IRA-integrated $8,000 ceiling in the Administration's tax proposal would, in practice, discriminate against employees of those employers unable to maintain conventional retirement plans.

The new ADP test will be nearly impossible to administer; it will be unfair; and it will drastically reduce allowable contributions in 401(k) plans that are clearly not abusive.

Section 401(k) plans must currently meet a two step anti-discrimination test known as the Actual Deferral Percentage ("ADP") test. The ADP test first expresses each employee's plan contributions as a percentage of his compensation. The ADP test then computes an average deferral percentage for the whole group of highly compensated employees and compares this average with an average deferral percentage computed for the group of non-highly compensated employees. The new ADP test, based on individual deferral ratios, is unworkable, unfair and too restrictive.

First, in an ADP test based on aggregates for both non-prohibited and prohibited group members, it is not necessary to monitor individuals' contributions precisely. The volatility and uncertainty associated with individual behavior are smoothed out in the averaging process. If high income individuals have to meet an individual test, most will not know whether they are in violation of the ADP test until near the end of the calendar year for which contributions are due. This will result inevitably in confusion and unproductive administrative expense.

Second, the new test will be unfair inasmuch as similarly situated individuals will be allowed to make drastically different contributions. An individual employee in the non-prohibited group could quite easily have a deferral ratio twice that allowed all employees in the prohibited group. Therefore, two employees, earning similar salaries, one in the prohibited and the other in the non-prohibited group, would be allowed substantially different benefits under the plan.

Finally, the overwhelming majority of existing plans, carefully designed by responsible employers to be non-discriminatory, would fail the new ADP test. In order to pass the test, all members of the prohibited group would have to drop their deferral ratios to levels very close to the average ratio for non-prohibited group members. This is clearly excessively restrictive and goes far beyond preventing any perceived abuse.

5. The rules covering the distributions from CODA's should be no more onerous than those for other qualified plans.

Any tax reform proposal should ensure that the rules for distributions from all qualified employer-sponsored retirement plans are generally uniform. Despite the economic equivalence between CODA's and other qualified employer-sponsored retirement plans, the Administration's tax proposal would establish rules for distributions from CODA's which excessively penalize employees participating in CODA's. The proposal establishes uniform early distribution rules for all employees participating in qualified employer-sponsored retirement plans, except CODA's. The proposed uniform rule permits distributions prior to 59 1/2 years of age subject to an excise tax. The CODA proposal prohibits distributions to active employees. The CODA distribution rules should be modified to permit employee elective contributions to be distributed on the same basis as distributions from other qualified plans.

6. There is no sound reason to limit the flexibility of tax-exempt and public sector employers and the equal opportunity of their employees to participate in 401(k) plans.

Employees of tax-exempt institutions and the public sector should have the same right to participate in tax-favored retirement plans as all other employees. Since the plans sponsored by public sector and tax-exempt employers are subject to the qualified plan overall maximum contribution or benefit limits (See IRC Section 415), there is no danger of abuse by allowing them to offer 401(k) plans. There is no reason to limit the flexibility of these employers in choosing the most appropriate kind of plan for their employees' needs. Moreover, only a small segment of tax-exempt employers (those exempt under IRC Section 501(c)(3)) are eligible to establish tax-deferred annuities (Section 403(b) plans); thus Section 403(b) plans are not a substitute for 401(k) plans for most employees of tax-exempt employers.

7. The amounts involved under Section 401(k) plans do not escape tax. Taxes are simply deferred until the employee retires and receives the income.

The key feature of a 401(k) plan is that Americans can defer taxes during their working years on income set aside for retirement and then pay taxes on that income as they receive it after retirement. There is no escape from paying taxes.

8. Employer-sponsored retirement plans encourage capital formation.

Private savings and capital formation should be encouraged. One way this goal can be achieved more effectively by Congress is through encouragement of broad-based retirement plans maintained by employers to provide income security for great numbers of employees. Capital formation achieved through employer-sponsored plans will benefit the economy while at the same time employees will obtain the benefit of participation in employee benefit plans such as Section 401(k) plans.

For all of the reasons set forth above, the present rules for Section 401(k) plans should be retained.

B. PROPOSAL TO REPEAL THE TEN-YEAR AVERAGING PROVISION

Generally, upon retirement a participant in a qualified benefit plan has an option to receive plan benefits either in a lump sum or in installments. Often the retiree will take the benefit in a lump sum because of immediate financial needs or because of the retiree's health or marital status. Retirees have been free to make this election on the basis of their financial needs and without regard to taxation. The ability to make this choice without regard to taxation has been an important part of the pension benefit made available to them.

More specifically, under current law, certain lump sum distributions from pension, profit-sharing and stock bonus plans are taxed under a special ten-year averaging method which is designed to minimize the impact of progressive tax rates on bunched income.

Under the ten-year averaging method, a separate tax is computed as if the retiree had no other ordinary income and received the lump sum distribution evenly over ten years. To reduce the tax burden on some distributions even further, retirees may receive a "minimum distribution allowance" tax free. The minimum distribution allowance decreases as the size of the distribution increases and is not available with respect to lump-sum distributions of $70,000 or more. As a consequence, and because the progressive tax rates of single taxpayers are used, large distributions are taxed at significantly higher rates than small distributions.

The Administration proposes to repeal the special ten-year forward averaging provision for distributions from qualified plans. The Administration maintains that the special ten-year averaging provision for certain lump-sum distributions encourages these distributions and is inconsistent with providing retirees with income throughout the entire period of their retirement.

The Administration recognizes that the original purpose of the ten-year averaging provision was to mitigate the effect of the progressive tax structure on retirees who receive all of their benefits in a single year. In making its proposal, the Administration assumes that this purpose would be served by permitting retirees to roll over lump-sum distributions into an IRA so that they would be taxed only as amounts subsequently are withdrawn from the IRA.

Why the Proposal Should be Rejected

1. The Administration's proposal would subject retirees receiving all their retirement benefits in one year to an unjust hardship. Although the Administration's program would reduce the progression in the tax rates, the amount of progression which would still exist would cause hardship for these retirees.

Participants in a retirement plan often make contributions over the lifetime of their employment. The amount of their retirement income, including employer contributions and investment income, is significant at retirement. Subjecting retirees to a one shot retirement tax on these amounts rather than phasing in the tax burden is a significant departure from the treatment originally anticipated when employees began saving for their retirement.

The Administration has noted that the original purpose of the ten-year averaging provision was to mitigate the effect of the progressive tax structure on individuals receiving all their benefits in a single year. While the Administration has reduced the progressivity of the tax rates in its proposal, there still exists a 20 point spread in the rates. Thus, retirement plan recipients would still be subject to an unjust hardship if they were to be taxed fully in the year they receive their distribution.

2. Ten-year averaging benefits retirees generally upon distribution of needed retirement benefits.

Ten-year averaging benefits retirees generally at the time of need. Taxation of lump sum distributions from qualified employee benefit plans under the ten-year averaging provision permits employees or their beneficiaries to receive the money from the pension plan without tax penalty. Under the Administration's proposal, recipients of lump sum distributions from a qualified benefit plan would be subject to an unjust hardship because they would be taxed ~~fully in~~ the year they receive their needed distribution.

3. Repeal of ten-year averaging would impair the value of retirement benefits, reduce flexibility and harm employees who have built retirement programs based on its availability.

The Administration's proposal to eliminate ten-year forward averaging would reduce retirement-planning flexibility for persons with more than one retirement plan who may wish to use the income from the secondary plan for a retirement home purchase or other large expenditure. The number of retirees with multiple retirement plans is increasing because of our mobile population and because of the increasing number of workers who move from one job to another. The number of persons retiring with benefits from more than one pension plan -- benefits they may want to use differently -- is growing and will continue to grow.

4. If ten-year averaging is repealed, repeal should be prospective and all accrued retirement benefits should be entitled to ten-year forward averaging.

The Administration's plan would completely repeal current averaging treatment for pre-retirement lump sum distributions and phase in, over six years, the averaging rules for retirement lump sum distributions. A change of this magnitude and scope affecting millions of retirees and Americans facing retirement will be disruptive and harmful to those who have anticipated the availability of this benefit.

We believe that ten-year forward averaging should be retained in the law. If, however, it is to be repealed, the Administration should consider a true grandfather allowing all benefits which have accrued as of January 1, 1986, to be entitled to ten-year forward averaging. Congress has acted in a similar fashion in the adoption of ERISA in 1974 when it preserved capital gains treatment for that part of the taxable portion of a lump sum distribution which was attributable to the employee's pre-1974 service.

C. PROPOSAL TO IMPOSE NEW NON-DISCRIMINATORY COVERAGE REQUIREMENTS ON EMPLOYEE PENSION AND WELFARE BENEFIT PLANS

Pension Benefit Plans

Current law requires that all qualified employer-sponsored retirement plans meet specific non-discriminatory coverage requirements. The plan must meet one of the following alternatives: (1) the plan must benefit at least 70% of all employees; (2) at least 70% of all employees must be eligible to participate in the plan, and of that group, 80% must benefit from the plan; or (3) the plan must provide benefits to a classification of employees found by the IRS not to be discriminatory in favor of employees who are officers, shareholders or highly compensated. In applying alternative (3), the terms "non-discriminatory classification," "officers," "shareholders," and "highly compensated" are defined by IRS, based on an investigation of the facts and circumstances of each particular case reviewed.

An objective of the Administration's proposal is to assure that "coverage under qualified plans...be made available on the broadest possible basis." To this end, all qualified employer-sponsored plans would be required to satisfy a new non-discriminatory coverage test. Under this test, the percentage of prohibited group members benefiting under the plan may not exceed 125% of the percentage of non-prohibited group members benefiting under the plan. Disregarded for purposes of this test are employees with less than one year of service (or two years of service if benefits are vested immediately, and it is not a 401(k) plan), employees who have not attained age 21, union employees and nonresident aliens. The prohibited group is made up of employees who presently, or at any time during a 3-year look-back period, are: a 1% or more owner; an employee earning $50,000 or more; one of the employees in the top 10% of employees by compensation or one of the highest three employees by compensation, but not if the compensation is less than $20,000; or a family member of a prohibited group member.

Under the proposal, the traditional "non-discriminatory classification" test (alternative (3), above) could be utilized by a plan to demonstrate non-discrimination only "in very limited situations where compelling business reasons" exist and the employer seeks a timely ruling from the IRS.

In addition to the 125% test, any classification used by the plan for defining participation would be required to be non-discriminatory on its face. The IRS would be permitted to define which classifications used by a plan to exclude employees from participation are non-discriminatory. Requiring an employee contribution as a condition of participation or excluding employees in a bona fide job category from participation would be permissible classifications. Also, integration with social security would continue to be permissible.

Why the Proposal Should be Rejected

1. The new non-discriminatory coverage test would create an enormous administrative burden on plans already attempting to cope with the changes required by TEFRA, DEFRA and REA.

It is generally recognized that employer-sponsored retirement plans are a sound way of providing retirement security for American workers. Aside from maintaining the Social Security system, the most effective means for Congress to assure an adequate living for the greatest number of older Americans is to continue tax incentives for employers to provide for their employees' retirement. Continued tax incentives will not be sufficient, however, if employers are discouraged from maintaining qualified plans due to unreasonable benefit requirements and administrative costs. While we do endorse the application of non-discriminatory requirements to qualified plans, it is necessary that these requirements be simple as well as effective and not unnecessarily displace current plan practices and result in increases in plan administrative costs.

The proposed non-discriminatory coverage test would cause employers to incur substantial administrative expense; and may compel the provision of significant additional and unnecessary benefits. It is likely that, if these qualified plan-related costs are perceived by employers as sufficiently high, the qualified plan will be terminated. Alternatively, employers may decide not to proceed with the institution of a qualified plan.

The proposal notes that "the test would require some qualified plans to provide benefits to additional numbers of non-prohibited group employees." Changes in benefit levels under qualified plans, effectuated solely to meet the new coverage tests, are not appropriate from a long-term pension policy perspective. Part-time and seasonal workers, who can no longer be excluded, will be over-pensioned, and duplication of benefits will result; even full-time rank and file employees will be over-pensioned, if their plans are made comparable to plans which cover professional, high-level or high technology employees. This result is contrary to an expressed policy of the proposal "that favorable tax treatment...be available only up to levels needed for reasonable retirement savings." In response to the need to increase the benefit level of the rank and file, employers will likely reduce the current compensation of this group commensurately. The rank and file will thus face the loss of a more valuable right -- current compensation -- in exchange for the promise of future retirement benefits.

A major purpose of the new coverage requirements is to give the IRS a mechanical enforcement procedure. In our view, the introduction of new regulatory procedures should not be part of a tax reform package. And, as there is no proof that the existing coverage requirements are inadequate, the IRS appears to be experimenting with enforcement procedures, and instituting unnecessarily complex rules, at the expense of plan sponsors and, ultimately, plan participants and beneficiaries.

2. This change, which raises no revenue, concerns national retirement income policy and therefore should be considered only by the appropriate Congressional committees.

National retirement income policy and retirement adequacy legislation are presently under consideration by several Congressional Committees and Subcommittees. It is counterproductive for the same issues to be involved in the crush of tax reform legislation, when a more deliberate approach is already underway.

3. The new test deprives any business with a variety of operations of the flexibility necessary to fashion benefit

programs to best meet the needs of a diverse employee group.

It is common, in today's business environment, for a business with a variety of operations to maintain non-comparable employee benefit plans. The decision not to force all employees of a heterogeneous workforce into a single rigid qualified retirement plan structure is generally based on administrative impossibility and the need to remain competitive in attracting quality employees.

Under current law, benefits may be structured in such a way as to channel certain welfare benefits to those employees who are in greatest need of that type of coverage in lieu of retirement benefits or coverage under a thrift plan. Other employees, whose need for retirement benefits is more important, can, on the other hand, be afforded fewer welfare benefits. Similarly, among different types of qualified plans, coverage is often determined with respect to the best type of qualified plan for a particular salary level, age group or occupational group. This flexibility would be severely restricted under the new coverage test.

4. It is unlikely that coverage will be increased under the proposal's new coverage rules. It is likely that benefits will be made uniform at relatively low levels and the

highly compensated will retain the accustomed level of benefits by the utilization of arrangements outside the qualified plan area, such as non-qualified deferred compensation arrangements.

The proposal recognizes that "the proposed 125% coverage test would...require some qualified plans to provide benefits to additional numbers of non-prohibited group employees tend ing to increase the cost of these plans." However, the proposal naively assumes that the coverage test will not precipitate "change to the plans' benefit formulas" and that a plan will "offset any resulting increased costs by reducing the coverage of prohibited group members."

Coverage under qualified plans is already strictly regulated and must be available to employees on a broad basis. In further mandating coverage, a decrease in overall coverage is the likely outcome. To the extent the retirement needs of key employees cannot be met by qualified retirement plans, they will be met by compensation arrangements under which benefits inure generally only to the highly paid. Lower-income employees would, therefore, lose future qualified plan benefits and not benefit from the non-qualified arrangements that are established.

5. The new coverage test will discourage beneficial combinations of businesses. A small business wanting to expand its horizons, in order to enhance its capital and market position, will be dissuaded from continuing to maintain a qualified employee benefit plan.

The proposal recognizes that the new tests would severely affect businesses involved in expansion, yet the proposal makes limited and inadequate concessions in a situation where "an employer maintaining a qualified plan acquires another company and the acquired company did not maintain a qualified plan for its employees."

Merely permitting the resulting company to defer meeting the new coverage test for one year is not a remedy to the problems likely to arise when artificial constraints are placed on business decisions. When employee benefits is made a prime consideration in business expansion, rather than an administrative detail to be worked out after the transaction, small companies will be reluctant to enter into business combinations. If the proposal's new coverage rule prevails, and more adequate adjustment arrangements are not included, small high-technology companies with existing benefit arrangements will be discouraged from combining with a company where qualified retirement benefits have been minimal, despite the economic and financial advantages to such a combination. Similarly, companies with large groups of rank-and-file employees will be hesitant to acquire small, growth-oriented companies with higher salary structures or more generous qualified plans.

Welfare Benefit Plans

Under current tax law, an employee may exclude from income certain employer-provided benefits. With few exceptions, one of the requirements (for exclusion) is that the benefits be provided on a non-discriminatory basis. The non-discrimination requirement applies to many employee welfare benefit plans including group-term life insurance, self-insured medical benefits, dependent care assistance and all benefits in a cafeteria plan (I.R.C. Section 125). No such requirement applies to disability income benefits or insured medical benefits.

The tests for determining whether the benefit is provided on a discriminatory basis are different for each benefit. Thus, the groups of employees that may be excluded for the purposes of discrimination testing, the determination of the prohibited group and the consequences of providing benefits on a discriminatory basis are different for each benefit.

The Administration's proposal would revise the non-discrimination rules for welfare benefit plans in an attempt to make them uniform across different plans. Two results of particular interest to the insurance business flow from these proposals: (1) statutory non-discrimination rules would apply, for the first time, to insured health plans; and (2) the specifics of existing rules would be substantially changed.

We are not opposed to extending non-discriminatory requirements to insured health plans, provided that such requirements are workable and consistent with sound public policy objectives. However, we do not believe that an attempt should be made to develop a new and expanded set of non-discrimination rules for these plans in the context of the current tax reform efforts. Tax revenue, rather than public policy, is bound to be an important, if not overriding, consideration. This should not be the case; instead, the operating rules for these plans should be considered in a broader context by the appropriate Congressional committees.

Moreover, the specific proposals in the Administration's program appear to contain serious flaws. For example, the new "concentration test" would severely discriminate against small employers where the 20-employee prohibited group would be a very large percentage of the total work force. In addition, the requirement that each type and level of benefit be tested as a separate plan unduly restricts an employer's ability to offer flexibility in its benefit plans, is more difficult for smaller employers to satisfy, and is unnecessarily stringent in light of the stated goal. In addition, the "concentration test" measures the actual distribution of benefits under a plan against an arbitrary subset of the prohibited group, resulting in a completely ineffective test for large employers and an overly restrictive test for smaller firms.

D. PROPOSED MODIFICATIONS TO THE DISTRIBUTION AND DEDUCTION RULES FOR QUALIFIED PENSION PLANS, AND MODIFICATIONS OF THE TAX TREATMENT OF SECTION 403(b) ANNUITIES

The Administration proposes a series of changes to the current deduction and distribution rules applicable to qualified pension plans, and significant modifications of the tax treatment of Section 403(b) annuities. With respect to many of the proposed changes, our testimony briefly summarizes the current law, the proposed changes and their impact. An overriding consideration, however, is our view that the recent trend of piecemeal, revenue-driven changes to the qualified plan rules is wholly inappropriate for dealing with retirement income issues. Those issues should be addressed in a comprehensive fashion. When employers implement employee benefit plans they make long-term commitments to benefit continuation. For the private employee benefit system to prosper, government must follow a consistent and coherent long-term approach and not continually shift policies. Therefore, any changes impacting the private retirement system should be enacted in the context of a national retirement policy discussion.

TAX ON EARLY DISTRIBUTIONS

Present law discourages distributions from some but not all retirement plans. A 10% excise tax is imposed on distributions from qualified plans to a current or previous 5% owner, or from an IRA to the individual prior to death, disability or age 59 1/2. Profit-sharing, thrift, and 401(k) plans can permit in-service distributions for hardship, if a plan so provides, with no excise tax imposed if the recipient is not a 5% or more owner.

The Administration's proposal would impose a 20% excise tax on the taxable portion of distributions from any tax-favored retirement plan before the participant dies, becomes disabled, or attains age 59 1/2. The tax is reduced to 10% if the distribution is for a dependent's college expenses, purchase of a first principal residence, or replacement of unemployment benefits. Section 403(b) annuities would be made subject to the same distribution restrictions. If the distribution occurs after age 50 but before 59 1/2, amounts distributed will not be treated as a pre-59 1/2 distribution if paid out in life annuity form or in level payments over 180 months.

Our national policy should continue to encourage personal savings and capital formation as integral goals of a national retirement policy. There are serious questions whether existing penalties on early distributions serve or undermine such policy. For example, unless the employee's money has been in the plan for a long time, the penalty more than recaptures any benefit from the deferral of tax on the contribution and earnings. Increasing the penalty to 20% would exacerbate the problem. The whole concept of a penalty, including its purpose and its design, needs to be considered in a broad public policy context. Until then, we cannot endorse existing penalties let alone support the proposed extension of these penalties as proposed, which would encompass hardship situations.

Restricting tax-favored savings solely to provide a narrow definition of retirement income would result in reduced savings. The greatest negative impact would fall on younger and lower-paid workers as many would no longer participate in contributory plans.

In general, the current retirement savings system is successful in providing the major portion of accumulations to employees for retirement. This is accomplished in part by permitting employees some flexibility - by encouraging savings to meet other major needs and by providing a framework for savings. An important social contribution of tax policy favoring qualified plans is to encourage people - either individually or through company plans - to engage in disciplined savings.

CHANGES IN THE TAXATION OF DISTRIBUTIONS FROM CONTRIBUTORY PLANS

Distributions from plans providing for employee contributions, e.g., a thrift plan, are currently treated first as a tax-free recovery of employee contributions. Under a "three-year rule", annuity distributions which include employee contributions are treated first as tax-free recovery of employee contributions if the employee contributions will be recovered within three years. If employee contributions will not be recovered within three years, a fixed portion of each payment is recovered tax-free according to a formula based on life expectancy at the time distributions begin.

The Administration's proposal revises the current basis recovery rules. A withdrawal before the annuity starting date would be treated first as a taxable distribution. Thus, if an employee withdraws money from a plan, all fully taxable savings would be treated as withdrawn first and included in currently taxable income before the employee could have access to his or her own contributions on which taxes have already been paid.

The three year recovery rule would be repealed. Annuity distributions would be taxed according to an exclusion ratio established at the time of commencement based on standard recovery periods of 5, 10, 15, or 20 years, depending on which is nearest to life expectancy. If an annuitant's basis is not fully recovered at death, the remaining basis passes to the estate or heirs. If the annuitant outlives the recovery period, each additional installment is fully taxable.

Current law should be maintained. All contributory plans would be affected by a reordering of distributions and basis recovery rules. This reordering would be particularly onerous coupled with the tax on early distributions. Thrift and savings plans would be adversely affected as the inability to recover employee contributions first would greatly discourage employee participation, especially among younger and lower-paid workers. Plans maintained by governmental employers are affected as they generally require relatively high levels of employee contributions.

Moreover, the proposed new exclusion rules for lifetime annuities would result in older annuitants suddenly having increases in taxable income if they live past their life expectancy, as defined by the Treasury. This could result in real hardship.

PENALTIES ON INSUFFICIENT DISTRIBUTIONS - MINIMUM DISTRIBUTION RULES

At present, qualified plan distributions must commence, in at least specified amounts, by April 1st following the year of attainment of age 70 1/2 or, for non-5% owners, the year of retirement, if later. If insufficient amounts are distributed, plans are subject to disqualification.

Likewise, IRA and SEP (Simplified Employee Pension) distributions must commence by April 1st following the year of attainment of age 70 1/2. If insufficient amounts are distributed, an IRA or SEP owner must pay a 50% excise tax.

Tax-sheltered annuities are subject to no lifetime distribution rules, but are subject to after-death rules similar to qualified plans.

The Administration proposes to replace the sanction of plan disqualification with a 50% penalty tax that would apply to all tax-favored retirement plans, including tax-sheltered annuities. Thus, if the minimum amount required to be distributed exceeded the amount, if any, actually distributed, the difference would be subject to a 50% excise tax. Therefore, if plan distributions are not begun by age 70 1/2, a calculation is made of what should have been distributed that year and a 50% excise tax is levied against that amount even though the individual would have received no funds to pay the tax.

Imposing a 50% penalty on corporate plan participants would miss the target completely. The current penalty tax provisions for IRA's and SEP's are to ensure that "participant-owners" will request distributions which are solely within their control. With a corporate plan, generally it is the plan administrator who controls the timing and sufficiency of distributions. Thus, the Administration's proposal would penalize the employee for a violation made by the plan administrator. It simply does not make sense to penalize people because of a decision which they did not or could not control.

CHANGES IN EMPLOYER DEDUCTION RULES FOR QUALIFIED PLANS - PROFIT-SHARING OR STOCK BONUS PLANS

Under current law, employer deductions for contributions to profit-sharing or stock bonus plans are limited to 15% of aggregate compensation paid to covered employees during that year with a carryforward to a succeeding year of up to 25%.

The Administration proposes to repeal the 15% of aggregate compensation limit and, in its place, limit the contribution to such plans for any individual to 15% of the individual's compensation for the year. Contributions made in excess of the individual 15% limit could be carried forward and deducted in the succeeding year subject to the individual 15% limit for that year. If less than 15% of an individual's compensation were contributed, the unused limit could not be carried forward unless the individual's plan is a "retirement type" plan. A profit-sharing plan would be treated as a "retirement type" plan with respect to an individual in any year if the individual is an active participant in the plan and

- does not participate in any other qualified profit-sharing or stock bonus plan sponsored by the employer;
- contributions are made or allocated according to years of service;
- no distributions or loans are available before separation from service, death, or disability; and
- the plan is not top-heavy.

The current 15% aggregate deduction limit should be maintained. Profit-sharing plans and stock bonus plans allow an employer to share profits with employees on a retirement savings basis. There is no precedent or rational policy justification for instituting the 15% individual deduction limit on top of the already applicable Section 415 limitations. Apparently, the Administration simply desires to severely restrict profit-sharing and stock bonus plans.

The proposal, if adopted, would preclude employer flexibility in weighting allocations for longer-service employees. It would effectively reduce retirement savings for many lower-paid participants in plans where contributions are based on seniority. Additionally, it appears that the proposal directly precludes integration with Social Security where the employer wants to put in a maximum contribution. These are significant problems in fashioning a meaningful employee benefit for both the sponsoring employer and employee.

EMPLOYER DEDUCTION LIMITS FOR ALL COMBINATIONS OF DEFINED CONTRIBUTION AND DEFINED BENEFIT PLANS

At present, if an employer maintains both a pension plan and a profit-sharing or stock bonus plan, total deductible contributions are limited to the greater of 25% of the aggregate compensation paid during the year to employees covered by the plans, or the amount necessary to meet the minimum funding standard for the pension plan. It is important to note that the Internal Revenue Code makes the technical distinction between "pension" plans and Section 401 qualified plans that are not "pension" plans, i.e., profit-sharing and stock bonus. Thus, contributions to a defined benefit pension plan and a money purchase pension plan are not subject to the 25% of aggregate compensation limit.

The Administration's proposal extends the 25% of aggregate compensation limit to combinations of defined benefit plans and money purchase plans. Thus, regardless of the type of plans maintained by the employer, the corporate deduction would be limited to the greater of 25% of aggregate compensation for covered employees or the amount necessary to meet the minimum funding standard for the defined benefit plan.

The Administration's proposal would negatively impact many small employers' plans. In closely held corporations where a defined benefit plan is in place providing benefits to longer-service older employees, it would be impossible for the employer to implement a meaningful retirement benefit (a money purchase plan) for the younger and shorter-service employees as a result of this proposed limitation. A major goal of retirement policy is to increase coverage for younger, shorter-service employees. This proposal would frustrate that effort. Current law correctly provides for a more favorable deduction rule when a money purchase plan is combined with a defined benefit plan. A money purchase plan involves a binding legal commitment to make specified annual employer contributions to a retirement plan subject to minimum funding standard requirements. A profit-sharing plan, on the other hand, includes no such commitment by an employer. The current deduction rules encourage employers to adopt money purchase plans rather than profit-sharing plans.

PROPOSED MODIFICATION OF SECTION 403(b) PROVISIONS

Section 403(b) permits employees of certain tax-exempt and state or local educational organizations to defer the receipt of cash compensation and to have their employer contribute the deferred amount to an annuity contract or custodial account. Generally, income tax on such deferred amounts and on income earned by them is not payable until the employee receives a distribution of benefits from the annuity or custodial account.

The Administration's proposal would repeal certain special flexible contribution limits that currently apply only to Section 403(b) annuities and custodial accounts. Moreover, it would prohibit distributions from Section 403(b) annuities except upon separation from service, attainment of age 59 1/2, death or disability, and thus would apply distribution rules to Section 403(b) plans that are more restrictive than the distribution rules applicable to most qualified plans.

The proposal would also prohibit application of the doctrine of constructive receipt to Section 403(b) annuities and custodial accounts. The doctrine of constructive receipt is a tax rule which the Internal Revenue Service currently applies to Section 403(b) annuity plans, but not to other qualified plans.

Unlike most qualified pension and profit-sharing plans, which are funded primarily with employer contributions, many Section 403(b) plans are funded by employee contributions made through an annual reduction in salary. Under this arrangement, therefore, the employee and not the employer is primarily responsible for funding retirement income.

Since the enactment of the Employee Retirement Income Security Act of 1974 ("ERISA"), Congress has recognized that the level of salary reduction contributions that an employee of a tax-exempt organization or public school can afford early in his career may be significantly lower than the contributions he can afford in later years. An employee's initial lack of resources may prevent him from funding his 403(b) plan in an adequate and timely manner.

The special limits, frequently referred to as "catch-up limits," are set forth in Code Section 415(c)(4). They are available to employees of educational organizations, hospitals, home health service agencies, and churches. Under Section 415(c)(4), an eligible employee may contribute to his Section 403(b) annuity or custodial account an amount which may exceed the contribution otherwise allowable under the general Section 415 limit, if it is necessary to allow him to "catch up" for years in which he did not make his allowable contribution.

As recently as 1982, when it enacted the Tax Equity and Fiscal Responsibility Act ("TEFRA"), Congress had occasion to reconsider and affirm the Section 415(c)(4) catch-up provisions. At that time, TEFRA extended the benefits of those provisions to church employees, a group whose Section 403(b) contributions were previously governed by the general Section 415 limit only.

The limits on Section 403(b) contributions under current law are no more generous and often less generous than the limits applicable to other retirement plans. The employee who utilizes the catch-up provisions is not obtaining tax benefits larger or sooner than one who contributes the maximum from the beginning of his career. All these provisions do is provide important flexibility. Accordingly, preservation of the existing limits on Section 403(b) contributions, including the catch-up limits, is appropriate. The need for flexible Section 403(b) contributions, which Congress has reaffirmed since 1974, still exists.

The rules governing distributions from Section 403(b) plans should not be more onerous than the rules governing distributions from qualified pension and profit-sharing plans. One of the principal stated goals of the Administration's proposal is to unify the rules governing benefit distributions from qualified plans. Despite this goal, the proposal would prohibit any distribution of benefits from a Section 403(b) annuity or custodial account before the occurrence of one of the following events: separation from service; death; disability; or the attainment of age 59 1/2. The distribution rules that would apply to most other qualified plans, on the other hand, do not require the occurrence of a specific event to permit a benefit distribution.

The proposed restrictions will have the counterproductive effect of discouraging retirement savings by participants in Section 403(b) programs. The overwhelming majority of Section 403(b) participants are middle-income wage earners, the largest group of which are public school teachers. While these employees use Section 403(b) annuities for retirement purposes, their willingness to do so is materially affected by the fact that amounts are accessible prior to retirement. If that accessibility is eliminated, there is a high likelihood that many of these employees will cease to participate. Whereas restrictions and penalties on withdrawals have relatively little importance to upper-income employees, they act as a powerful deterrent against retirement savings by the lower-paid.

CONCLUSION

We are firmly convinced that the Administration's proposals regarding qualified retirement programs are not in the best interest of workers, their families and the country. Our current system of encouraging employer-provided plans has worked remarkably well. Coverage is widespread; it is provided through an efficient, effective, flexible group mechanism; and it has relieved government of the responsibility to assure working Americans of an adequate retirement income.

The specific proposals advanced by the Administration are inconsistent with our country's long-established policy favoring employee benefits, and we urge your Subcommittee to reject them. To impose any tax on employee benefits would establish a bad precedent and could signal to employers and employees that the proposed taxes are only the first step. We urge Congress to continue the present system of tax incentives so that our employee benefit programs remain intact.

We appreciate having the opportunity to make this statement. We would be happy to attempt to furnish any additional information which the Subcommittee might think helpful.

Respectfully submitted,

AMERICAN COUNCIL OF LIFE INSURANCE

Senator NICKLES. Mr. Naughton, thank you very much for your comments.

I would echo your initial statement of concern that a lot of the changes that were proposed by Treasury, particularly the latest change, were strictly for additional revenue and, I think, had very little thought given as far as pension policy and fringe benefit policy.

That does need to be considered and that is what we are doing today and will continue doing.

Ms. Ferguson mentioned—and I think there is some truth to it—that a lot of section 401(k)'s would be transfers from, really, defined-contribution plans. Would you agree with that?

Mr. NAUGHTON. Well, I think that there is no question that there have been a great number of defined-contribution plans that have been amended and converted over to section 401(k). To characterize that as that all section 401(k) plans are basically amendments and a shifting of assets is totally incorrect.

We did a survey last year, the Mass Mutual, that indicated that about 40 to 50 percent of all section 401(k) plans were brand new plans; not amended plans or modified plans that were previously defined-contribution plans.

Senator NICKLES. Forty to fifty percent were new plans?

Mr. NAUGHTON. Forty to fifty percent.

Senator NICKLES. And they were in addition to, not in exchange for?

Mr. NAUGHTON. The survey did not go into detail as to whether they were in addition to a defined-benefit program, but they were not in exchange for a defined-contribution plan.

Senator NICKLES. If possible, I would like to have that.

Mr. NAUGHTON. I would be happy to provide that survey. I have it with me and I can leave it with you.

Senator NICKLES. I would appreciate.

[Information supplied follows:]

401(k)
SURVEY REPORT

MASS MUTUAL

INTRODUCTION

Since 1983, implementation of 401(k) salary reduction plans has increased dramatically. Concomitant with this increased usage is an increase in the need for information. Consequently, as part of Mass Mutual's continuing effort to keep the pension industry informed of major trends in the marketplace, we present our second annual report on 401(k) plans.

This report is compiled from an extensive survey administered to over 2000 companies and businesses in June of 1985. The survey encompassed a broad cross-section of the pension industry and, as such, it represents one of the few studies that examines small as well as large plan trends.

Over 16% of the companies surveyed responded to our questionnaire. We would like to take this opportunity to express our sincerest appreciation to all those who took the time to complete this questionnaire and we hope the results prove useful to them.

SUMMARY COMMENTS

— In spite of the uncertainty associated with the potential tax restructuring, establishment of 401(k) plans is still increasing.

— Although 401(k) plans were initially established by large companies, the trend is toward increased small company utilization of 401(k)s.

— Substantial yearly increases in employee participation rates and deferral percentage rates are indicative of increasing employee utilization of 401(k) plans.

— The guaranteed interest account and the money market fund are the most popular investment options. When offered, employees invest nearly 60% of their funds in the guaranteed interest account. Further, the plans that offer the guaranteed option obtain greater employee participation.

— The majority of plans are designed to include the salary reduction feature in conjunction with a company matching contribution.

— For the higher-paid one-third employee group, the potential tax advantage of a 401(k) plan is most effective at eliciting participation. Conversely, for the lower-paid two-thirds group, it was found that the employer matching contribution is most effective at encouraging participation.

— Although most plans establish some requirements for eligibility, in general, the requirements do not preclude a significant portion of the staff from plan participation.

— The majority of plans offer a loan provision and magnanimous hardship withdrawal provisions in order to encourage plan enrollment.

COMPANY PROFILE INFORMATION

Each respondent was requested to provide basic information on its industry group, annual sales, and number of employees, in order to assist us in identifying trends in particular industries and company size categories.

The results indicate that the probability of a firm offering a salary reduction program is a direct function of the company's size. However, in comparison with last year's data, this year a greater percentage of small and mid-sized companies offer 401(k) plans. In 1982 and 1983, primarily large companies took the initiative in instituting salary reduction programs, but more recently, the smaller companies have recognized the advantages of offering an employee supported retirement program. Consequently, an increase in plan implementation among small and mid-sized companies is evident.

The following tabular illustration demonstrates the relationship between 401(k) activity and a company's annual sales and staff size.

ANNUAL SALES (in millions)	**SPONSOR 401(k) PLAN**	**DO NOT SPONSOR 401(k) PLAN**
$10 or less	18 (27.3%)	48 (72.7%)
$10 - $50	35 (33.7%)	69 (66.3%)
$50 - $100	23 (62.2%)	14 (37.8%)
Over $100	30 (51.7%)	28 (48.3%)

NUMBER OF EMPLOYEES	**SPONSOR 401(k) PLAN**	**DO NOT SPONSOR 401(k) PLAN**
500 or less	61 (28.6%)	152 (71.4%)
501 - 1000	16 (44.4%)	20 (55.6%)
1001 - 5000	25 (45.5%)	30 (54.5%)
Over 5000	16 (76.2%)	5 (23.8%)

An analysis of 401(k) activity by industry demonstrates the substantial divergence in salary reduction plan availability. In comparison to health care organizations, financial service and food and beverage companies are twice as likely to utilize 401(k) plans. The table below illustrates the areas of greatest industrial divergence in 401(k) activity.

INDUSTRY	**SPONSOR 401(k) PLAN**	**DO NOT SPONSOR 401(k) PLAN**
Manufacturing	39.8%	60.2%
Financial Services	42.3%	57.7%
Health Care	21.4%	78.6%
Utilities	37.5%	62.5%
Food/Beverage	40.0%	60.0%
Diversified Services	39.0%	61.0%

There is no unequivocal explanation as to why some industries are more likely than others to sponsor 401(k) plans. 401(k) utilization could be a function of industry profitability, work force age, labor market structure, or benefit package composition.

Over 80% of the plans surveyed make relatively small annual contributions of one million dollars or less. This data asserts that the survey was successful in obtaining a representative sample of small 401(k) plans. It is also worth noting that total plan assets are evenly distributed up to the 20 million dollar mark.

TOTAL ANNUAL CONTRIBUTIONS

CONTRIBUTIONS (000)	# OF PLANS	% OF PLANS
0 - 250	46	43.8%
250 - 1000	43	41.0%
Over 1000	16	15.2%

TOTAL PLAN ASSETS

ASSETS (000)	# OF PLANS	% OF PLANS
0 - 250	37	34.6%
250 -1000	30	28.0%
1000 - 20000	32	29.9%
Over 20000	8	7.5%

PLAN INFORMATION

The results indicate that nearly 80% of the firms with 401(k) plans offer some type of company contribution. The most popular plan provision involves a salary reduction feature in conjunction with a company matching contribution.

TYPE OF CONTRIBUTION	# OF PLANS	% OF PLANS
Salary reduction only	24	21.1%
Salary reduction plus company match	43	37.7%
Salary reduction plus company discretionary (from profits)	21	18.4%
Salary reduction plus company match plus company discretionary (from profits)	26	22.8%

In comparison with last year's data, there has been a significant increase in the number of plans offering employer discretionary contributions. The increase in discretionary contribution utilization is a function of the greater small company representation in this year's survey in conjunction with the tendency of small firms to amend existing profit sharing plans.

NEW VS. AMENDED PLANS

	# OF PLANS	% OF PLANS
New plans	50	42.4%
Amended plans	68	57.6%

The data indicates that 401(k) activity is continuing on its growth trend with a number of plans being initiated in the first half of 1985. If implementation continues at the current rate, more plans will be initiated in 1985 than in any previous year.

401(k) ACTIVITY

YEAR INITIATED	# OF PLANS	% OF PLANS
Prior to 1983	4	8.5%
1983	17	36.2%
1984	16	34.0%
1985 (through June)	10	21.3%

An analysis of plan initiation by firm size indicates that although 401(k) plans were initially established by large corporations, the trend is toward increased small company utilization of 401(k).

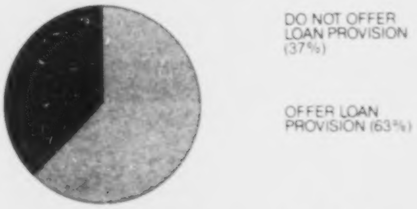
PLAN PROVISIONS

Information was requested on various plan provisions in order to assess current trends in program composition. Issues of primary interest in the plan provision area include: loan administration, hardship withdrawals, eligibility requirements, vesting schedules, contribution limits, employer matching contributions and employee groups covered by the plan.

LOAN PROVISIONS

As illustrated below, 63% of 401(k) plans contain a loan provision. Although loan provisions are predominant among 401(k) plans, the data indicates that only 1.2% of the plan participants actually utilize the loan option. The meager loan provision utilization may be attributable to small account balances or to a lack of employee awareness of loan availability.

LOAN PROVISION



For those employees who do utilize a plan's loan provision, the survey found the most prevalent interest rate on borrowed funds is the rate of return on plan assets, i.e. the fixed account rate.

LOAN REPAYMENT RATE

	% OF PLANS
Investment rate of plan assets	35.6%
Prime rate	31.1%
Prime rate plus one percent	28.9%
Other	4.4%

An analysis of loan provision availability by plan size indicates that the probability of a firm offering a loan provision is an inverse function of the size of the 401(k) plan. One potential explanation for this divergence is the increased administrative complexity associated with greater staff size.

LOAN PROVISION BY PLAN SIZE

PLAN SIZE (# OF PARTICIPANTS)	OFFER LOAN OPTION	DO NOT OFFER LOAN OPTION
0 - 500	58.5%	41.5%
501 - 1000	74.6%	25.4%
Over 1000	43.0%	57.0%

HARDSHIP WITHDRAWALS

Although final regulatory parameters on hardship withdrawals have yet to be established, companies appear to be willing to allow withdrawals of salary reduction employee contributions for such reasons as major medical expenses, college tuition, and primary residence purchase.

The data indicates that 89% of the plans allow hardship withdrawals from salary reduction employee contributions and 56% of the plans allow withdrawals from vested employer contributions. Additionally, 83% of the companies would approve a hardship withdrawal for major medical expenses; 83% would allow withdrawals for college tuition, and, 78% would approve a withdrawal for the purchase of a primary residence.

EMPLOYEE GROUPS COVERED

The following data indicates that the majority of 401(k) plans cover salary exempt and salary non-exempt employees. It is also noteworthy that 24% of the plans cover salary exempt, salary non-exempt and hourly non-union employees.

EMPLOYEE GROUPS COVERED BY PLAN

GROUP COVERED	# OF PLANS	% OF PLANS
Salaried non-exempt only	2	2.2%
Salaried exempt and non-exempt	46	51.1%
Salaried exempt and hourly non-union	6	6.7%
Salaried exempt, salaried non-exempt and hourly non-union	22	24.4%
Salaried exempt, salaried non-exempt, union and hourly non-union	14	15.6%

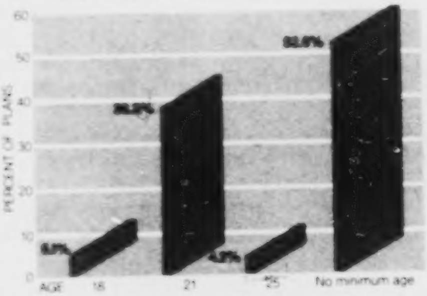
ELIGIBILITY REQUIREMENTS

Although most plans do establish some requirements for eligibility, in general, the requirements are magnanimous: they do not preclude a significant portion of the staff from participation in the plan. The requisite minimum age for plan participation ranged from 18 to 25 with the most common requirement being 21.

MINIMUM AGE ELIGIBILITY REQUIREMENT

MINIMUM AGE	# OF PLANS	% OF PLANS
18	6	5.1%
21	45	38.2%
25	5	4.2%
No minimum age requirement	62	52.5%

MINIMUM AGE ELIGIBILITY REQUIREMENT



Over 86% of the plans establish a minimum service requirement for plan participation. The required minimum service prerequisite for plan participation ranged from 1 month to 3 years with the most common service requirement being 1 year.

MINIMUM SERVICE REQUIREMENT

SERVICE REQUIREMENT	# OF PLANS	% OF PLANS
No requirement	16	13.6%
3 months or less	8	6.8%
6 months	12	10.2%
1 year	70	59.3%
2 years	4	3.3%
3 years	8	6.8%

An analysis of minimum age eligibility requirements by plan size indicates that the establishment of minimum age requirements is an inverse function of plan size, and that the minimum age requirements of mid-sized plans are, in general, lower than the age requirements of large and small plans.

MINIMUM AGE REQUIREMENT BY PLAN SIZE

PLAN SIZE (# OF PARTICIPANTS)	% OF PLANS	AVERAGE AGE REQUIREMENTS
0 - 500	60.4%	21.5
501 - 1000	22.6%	19.5
Over 1000	17.0%	21.5

An analysis of minimum service eligibility requirements by plan size indicates that the establishment of minimum service requirements is an inverse function of plan size, and that large plan minimum service requirements are, in general, higher than the service requirements of small plans.

MINIMUM SERVICE REQUIREMENT BY PLAN SIZE

PLAN SIZE (# OF PARTICIPANTS)	% OF PLANS	AVERAGE SERVICE REQUIREMENTS
0 - 500	68.5%	1.0 Years
501 - 1000	12.6%	1.2 Years
Over 1000	18.9%	1.5 Years

MAXIMUM SALARY REDUCTION CONTRIBUTION

The survey results indicated a broad range (1 - 25%) for the maximum percentage of salary reduction contributions allowed. However, the distribution was basically pentamerous with over 85% of the plans limiting salary reduction contributions to 6%, 10%, 15%, 20% and 25% of permissible compensation.

MAXIMUM % SALARY REDUCTION CONTRIBUTION

CONTRIBUTION LIMIT	# OF PLANS	% OF PLANS
6%	14	12.3%
10%	37	32.5%
15%	30	26.3%
20%	7	6.1%
25%	10	8.8%
Other	16	14.0%

MINIMUM SALARY REDUCTION CONTRIBUTION

Less than 30% of the plans establish a minimum employee salary reduction contribution as a prerequisite for plan participation. However, of the plans requiring a minimum contribution, the most prevalent provision is a 6% salary reduction contribution.

MINIMUM % SALARY REDUCTION CONTRIBUTION

CONTRIBUTION REQUIREMENT	# OF PLANS	% OF PLANS
None	79	71.2%
1%	6	5.4%
2%	6	5.4%
3%	1	.9%
5%	2	1.8%
6%	17	15.3%

EMPLOYER MATCHING CONTRIBUTIONS

78% of the plans offer some form of employer matching contribution in order to elicit employee participation. 42.2% of the plans offer a 50¢ match per dollar of employee contribution. In comparison with last year's data, this year significantly more plans are matching on a discretionary basis. This is indicative of the small company tendency to convert existing profit sharing plans to include the salary reduction feature.

EMPLOYER MATCHING CONTRIBUTIONS

MATCH PER DOLLAR	# OF PLANS	% OF PLANS
.25 or less	13	15.7%
.26 - .50	35	42.2%
.51 - .75	2	2.4%
.76 - 1.00	8	9.6%
Over 1.00	1	1.2%
Discretionary Match	10	12.0%
Multiple factors	14	16.9%

An analysis of employer matching contributions by plan size indicates that there is less diversity in the employer contribution provisions of mid-size plans. The chart following illustrates the divergence of employer matching contributions by plan size.

EMPLOYER MATCHING CONTRIBUTION

CONTRIBUTION PROVISION	500 EMPLOYEES OR LESS % OF PLANS	501 - 1000 EMPLOYEES % OF PLANS	OVER 1000 EMPLOYEES % OF PLANS
.25 or Less	16.3%	23.1%	22.2%
.26 - .50	38.8%	61.5%	27.8%
.51 - .75	4.0%	0 %	5.6%
.76 - 1.00	8.2%	15.4%	11.1%
Other	24.5%	0 %	33.3%
Match plus discretionary amount	8.2%	0 %	0 %

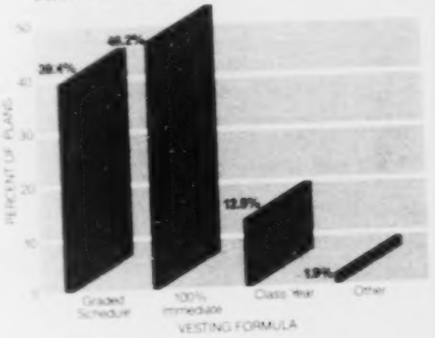
COMPANY STOCK

13 percent of the plans make employer matching contributions with company stock. Further, an analysis by plan size indicates that there is a direct relationship between company size and employer contributions of company stock.

VESTING

Over 46% of the plans vest contributions 100% immediately. One potential explanation for the prevalence of immediate vesting is this formula's administrative simplicity. The vesting formula breakdown is graphically illustrated below.

VESTING FORMULAS



INVESTMENTS

The data indicates that over half of the plans offer 3 or fewer alternative investment options. Additional analysis asserts that company stock is the only option offered for over 30% of the single investment alternative plans.

NUMBER OF INVESTMENT OPTIONS	# OF PLANS	% OF PLANS
1	24	21.1%
2	30	26.3%
3	40	35.1%
4	18	15.8%
5	2	1.7%

The following table demonstrates that the most prevalent investment options are: money market funds, guaranteed interest accounts and non-indexed equity funds. The data indicates that, due to the volatile interest rate climate of the past few years, products (like guaranteed interest contracts) that offer stability and guaranteed growth are increasing in popularity.

INVESTMENT OPTION UTILIZATION

OPTION	# OF PLANS USING	% OF PLANS USING
Marketable bond fund	38	32.2%
Equity fund (non-indexed)	70	59.3%
Index fund	4	3.4%
Company stock	19	16.1%
Guaranteed interest account	72	61.0%
Real Estate	6	5.1%
Options/futures	1	.8%
Money market fund	72	61.0%

An analysis of the number of investment options by plan size indicates that the number of investment alternatives is a direct function of plan size. Noteworthy is the fact that 33% of the single investment alternative plans are firms offering only a company stock account.

INVESTMENT OPTIONS BY PLAN SIZE

# OF INVESTMENT OPTIONS (plans with 500 participants or less)	% OF PLANS
1	30.6%
2	26.4%
3	33.3%
4	9.7%
5	0.0%

# OF INVESTMENT OPTIONS (plans with 501 - 1000 participants)	% OF PLANS
1	13.0%
2	30.4%
3	47.8%
4	8.8%
5	0.0%

# OF INVESTMENT OPTIONS (plans with over 1000 participants)	% OF PLANS
1	0.0%
2	26.1%
3	26.1%
4	39.1%
5	8.7%

An analysis of average percentage participation figures indicates that guaranteed interest accounts and company stock accounts receive the greatest proportion of 401(k) monies. The high participation rate for company stock is misleading due to its disproportionate representation in single investment option plans.

INVESTMENT OPTION PARTICIPATION

INVESTMENT OPTION	AVERAGE % PARTICIPATION
Bond fund	15.5%
Equity fund	32.7%
Index fund	20.0%
Company stock	45.0%
Guaranteed interest account	57.9%
Money market fund	30.9%

PLAN EXPERIENCE

Regardless of salary level, employee participation in 401(k) plans is prolific. As expected, the participation rate for the top-paid ⅓ employee group is slightly higher than the participation rate for the lower-paid ⅔ group.

PARTICIPATION RATES

	LOWER-PAID ⅔	HIGHER-PAID ⅓	OVERALL
AVERAGE PARTICIPATION RATES	66.4	79.7	73.0

The survey results indicate an average salary level of $30,515.38 for the ⅓, ⅔ discrimination test. The results of an Investment Company Institute study of the IRA market asserts that less than 25% of the households with an income of under thirty thousand utilize IRA's. The differential between IRA utilization (25%) and 401(k) participation (66.4%) for lower-paid employees is indicative of this group's preference for 401(k) salary reduction programs. The lower-paid employee group's preference for 401(k) plans may be attributable to the company matching contribution provision inherent in most plans.

An analysis of average participation rates by plan size indicates that the level of employee participation is a direct function of the size of the plan.

AVERAGE PARTICIPATION RATES BY PLAN SIZE

PLAN SIZE (# of participants)	LOWER-PAID ⅔	HIGHER-PAID ⅓	OVERALL
0 - 500	59.8%	72.5%	66.1%
501 - 1000	63.1%	83.6%	73.4%
Over 1000	68.9%	81.6%	75.3%

DEFERRAL PERCENTAGE RATES

As expected, the average deferral percentage rates are higher for the top-paid ⅓ than for the lower-paid ⅔.

DEFERRAL RATES

	LOWER-PAID ⅔	HIGHER-PAID ⅓	OVERALL
Average deferral percentage rate	3.7	5.6	4.7

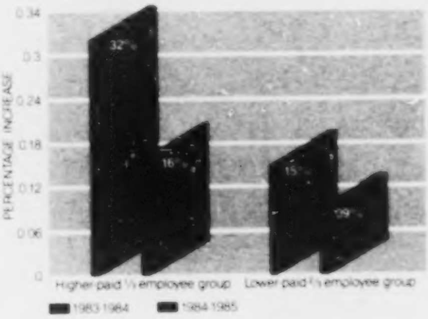
An analysis of average deferral percentage rates by plan size indicates that the average deferral percentage rate is an inverse function of the size of the 401(k) plan.

AVERAGE DEFERRAL RATES BY PLAN SIZE

PLAN SIZE (# of participants)	LOWER-PAID ⅔	HIGHER-PAID ⅓	OVERALL
0 - 500	4.2%	5.6%	4.9%
501 - 1000	3.5%	5.4%	4.5%
Over 1000	3.5%	5.3%	4.4%

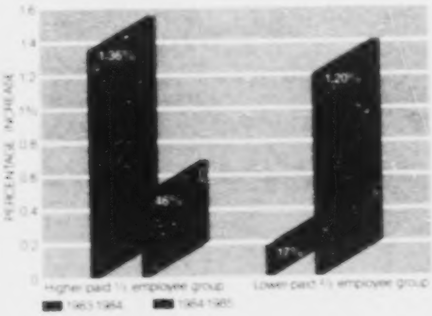
Respondents were requested to provide deferral and participation rate information for the past three years in order to assist us in determining the direction and magnitude of any trends in employee utilization of 401(k) plans. In general, regardless of employee salary level, deferral and participation rates have increased over time. Specifically, the data indicates that the participation rate for the higher-paid ⅓ and the lower-paid ⅔ employee groups exhibited an average annual increase of .81% and .80% respectively. Further, the deferral rate for the higher-paid ⅓ employee group increased by an average of .22% annually, while the deferral rate for the lower-paid ⅔ group increased by an average of .11% annually. The yearly deferral and participation rate increases are graphically illustrated below.

YEARLY PERCENTAGE INCREASE
IN DEFERRAL PERCENTAGE RATES



YEARLY PERCENTAGE INCREASE

IN EMPLOYEE PARTICIPATION RATES



Plans in the top and bottom quartile of employee participation were analyzed to determine the attributes that elicit and deter 401(k) plan participation. The results indicate that, in general, plans with high employee participation possess the following attributes:

- guaranteed account and money market account investment options
- employer matching contribution provision
- loan provision
- hardship withdrawal availability from salary reduction employee contributions and vested employer contributions

The results indicate that, in general, plans with low employee participation possess the following attributes:

- company stock account as the only investment option
- absence of an employer matching contribution provision
- minimum salary reduction contribution requirement

DISCRIMINATION TEST

In order to verify compliance with governmental discrimination guidelines, the majority of plans monitor deferral percentage rates on either a quarterly or semiannual basis. Further, a comparison with last year's data asserts that the monitoring frequency is decreasing.

DISCRIMINATION TEST

FREQUENCY	# OF PLANS	% OF PLANS
Monthly	12	12%
Quarterly	34	34%
Semiannually	25	25%
Annually	15	15%
End of plan year only	14	14%

DISCRIMINATION REMEDIES

Sponsors were asked about the type of adjustment they would make to meet the actual deferral percentage limits for the higher-paid ⅓ if it were necessary to limit the contributions. Nearly 50% of the respondents indicated a preference for reducing the highest deferral percentage of the top-paid ⅓. The discrimination remedy survey results are illustrated below.

DISCRIMINATION REMEDIES

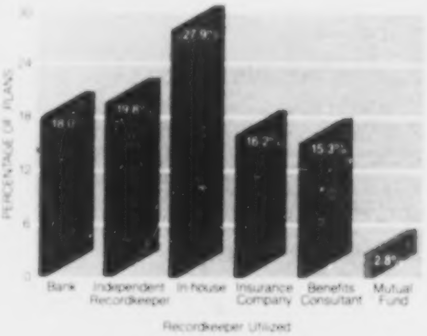
REMEDIES	% OF PLANS
Reduce the highest deferral percentage of the top-paid ⅓ group	48.3%
Reduce the contributions for the top-paid ⅓ proportionately	31.0%
Convert a portion of the salary reduction contributions to after tax contributions	18.4%
Other	2.3%

ADMINISTRATION

RECORDKEEPING

The increase in government regulation and investment sophistication necessitates the development of efficient recordkeeping systems. The graphic illustration below indicates that most companies perform this arduous task internally. However, in comparison to last year's data, companies are increasingly seeking expert assistance for development and maintenance of these systems. Further, an analysis of recordkeeping systems by plan size indicates that small plans utilize expert assistance more often than large plans.

RECORDKEEPING



In comparison with last year's data, both changes in the amount of future contributions and transfers of existing assets among investment options are being allowed less frequently. Further, it is noteworthy that these changes are most commonly allowed on a semiannual basis.

CHANGES IN THE AMOUNT OF FUTURE CONTRIBUTIONS

FREQUENCY OF CHANGE	# OF PLANS	% OF PLANS
Monthly	9	7.8
Quarterly	27	23.3
Semiannually	44	37.9
Annually	26	22.4
Anytime	6	5.2
Other	4	3.4

TRANSFER OF EXISTING ASSETS AMONG INVESTMENT OPTIONS

FREQUENCY OF TRANSFER	# OF PLANS	% OF PLANS
Monthly	5	5.3
Quarterly	23	24.5
Semiannually	32	34.0
Annually	26	27.7
Anytime	8	8.5

PLAN RELATIONS

INCENTIVES FOR PARTICIPATION

Respondents were asked to rank the following items in terms of effectively encouraging employee plan participation. For the higher-paid one-third employee group, the results indicate that the potential tax advantage of a 401(k) plan is most effective at eliciting participation. Conversely, for the lower-paid two-thirds group, it was found that the employer matching contribution is most effective at encouraging participation.

ELICITING PARTICIPATION FROM THE HIGHER-PAID ⅓

FACTOR	EFFECTIVENESS RANK	MEAN SCORE
Tax advantages	1	4.65
Savings for retirement	2	4.01
Employer matching contribution	3	3.82
Return on investment	4	3.81
Effective plan promotion	5	3.22

ELICITING PARTICIPATION FROM THE LOWER-PAID ⅔

FACTOR	EFFECTIVENESS RANK	MEAN SCORE
Employer matching contribution	1	4.32
Savings for retirement	2	3.96
Return on investment	3	3.83
Tax advantage	4	3.68
Effective plan promotion	5	3.31

MAJOR DRAWBACKS

Fifty-seven percent of the survey respondents think that employees perceive the limited access to funds to be the most critical drawback of 401(k) participation. This data portends the necessity of offering a loan provision as part of the 401(k) plan.

CONCLUSION

The survey results indicate that flexible compensation continues to proliferate with the adoption of new 401(k) plans and the amendment of existing plans to include the salary reduction feature. Although the majority of companies with under 5000 employees still do not offer plans, a comparison with last year's data indicates that small firms have significantly increased 401(k) utilization. Employees are also increasing utilization of these plans. Consistent growth in deferral and participation rates is indicative of an intensified employee desire to participate in individual retirement planning. Ultimately, increasing employee participation and expanding small company implementation portend continued growth in 401(k) usage.

This report exemplifies Mass Mutual's commitment to provide the pension industry with relevant information on pertinent issues. Other informational reports available from Mass Mutual include: Flexible Compensation - 401(k) Plans - A Guide for the Plan Sponsor; Survey of Defined Benefit Investment Practices; and, Pension and Investment Dynamics.

In addition to keeping the pension industry informed of significant trends, Mass Mutual is committed to satisfying the industry's product needs. As a pioneer in the 401(k) field, we offer the experience and expertise necessary to simplify and expedite the implementation process. Mass Mutual can provide assistance with any phase of 401(k) development.

PLAN DESIGN

Mass Mutual provides assistance in designing a plan to meet your 401(k) program's objectives. Furthermore, we will assist you in the future to make improvements and to keep your plan in conformance with legislative changes.

INVESTMENT MANAGEMENT

Mass Mutual provides a full range of financial services and a variety of investment accounts with varying objectives to meet the needs and goals of our 401(k) clients. We offer guaranteed contracts and commingled funds investing in common stocks, publicly traded bonds, and short-term investments.

With more than eighty investment professionals on staff, our portfolio managers are able to keep a step ahead of developing trends in an uncertain investment climate, and will manage your plan's assets in anticipation of these changes.

RECORDKEEPING

Mass Mutual offers a computer system that facilitates the detailed recordkeeping which is required to operate your 401(k) plan. This system not only insures efficient handling of day-to-day administration, but it also provides flexibility. Our sophisticated recordkeeping system maintains participant records, provides detailed financial information, allows for a variety of benefit payment options, and handles deposits and withdrawals on a timely basis.

COMMUNICATIONS

Mass Mutual provides assistance in communicating your 401(k) plan to employees. We supply enrollment aids such as 401(k) brochures, salary profiles, and slide shows. We work with our clients on an individual basis to establish a time table for communicating and implementing their 401(k) plan.

Senator NICKLES. I think that is an important fact. That is the type of thing I am trying to look for.

I will ask all of our panelists this question. All of you on this panel have mentioned your preference that section 401(k)'s, basically, be left alone and certainly not terminated as proposed.

You are probably also aware that many in Congress are looking at, instead of terminations, lowering the caps or limiting the amount of contributions. We've heard the terms $5,000 and $8,000. $5,000 is being kicked around in the House; $8,000 was in Treasury II.

Kathy, how would the $8,000 cap affect most of the Parker employees?

Ms. KUCHARSKI. Well, the section 401(k) plan is our only plan. So we would prefer an overall approach. Rather than just put a limit on a section 401(k) plan, we would rather see a limit put on plans across the board.

We did not convert a thrift plan. We set up a section 401(k) plan. Since, for most of our employees, this is the only means for savings for retirement, we would rather not see a cap put on the section 401(k).

Senator NICKLES. Would 90 percent of your employees be under a cap of $5,000 or $8,000 so it wouldn't make any difference; maybe that would just affect some of the higher paid employees?

Ms. KUCHARSKI. No. We have only had the plan in operation for approximately 20 months. I think the majority of the people who are contributing to the plan are already at that level.

Senator NICKLES. They would be at that level.

Ms. KUCHARSKI. Yes.

Senator NICKLES. It would be affecting a majority of plan participants?

Ms. KUCHARSKI. Yes.

Senator NICKLES. Mr. Koch.

Mr. KOCH. Senator, I think in our case we would prefer to see things stay the way they are. We have the overall $30,000 limit on the section 415 provisions, which would cover the ESOP, the section 401(k)—in our case, we still have a pension plan, too—rather than singling out the section 401(k) for its own individual cap.

Senator NICKLES. I'm just wondering, though, in your case with your employees—

Mr. KOCH. Either of those ceilings, I believe, would cover the vast majority of our employee group.

Senator NICKLES. I would think that in most companies, unless you had exceptionally high income levels or other types of systems, that most—I don't know what the percentages would be.

Mr. Naughton, do you care to comment on that? Do you think that an $8,000 cap, say, would cover most of the employees?

Mr. NAUGHTON. In our own plan at Massachusetts Mutual, clearly that would cover most employees. However, any cap at all, other than the section 415 cap which we already have of $30,000, in our view is really unnecessary.

There seems to be a bias here—I don't mean in this subcommittee, but in the administration's proposal—that retirement plans should be geared to and only benefit lower and middle-income employees. While we don't advocate that the higher paid employees should get rich and be fat cats, on the other hand we do advocate that they should benefit proportionately to their income.

So that a restriction of $5,000 or $8,000, we think, is inappropriate.

If, in fact, the Congress in their wisdom decides that some limitation beside the section 415 limit is applicable or should be applied to section 401(k) plans, we would think it ought to be a function of the section 415 limit—perhaps two-thirds of the section 415 limit—if that became necessary.

Senator NICKLES. Kathy, I understand you to be saying that the typical Parker Drilling employee would not have sufficient individual retirement savings without a section 401(k) plan?

Ms. KUCHARSKI. Well, I believe so. I have spoken to a lot of employees—field employees and corporate employees, kitchen employees.

Basically, 75 percent of our employees are out in the field. When the rig goes down, they go to another location. They might be working in Alaska, but their family is in Texas.

They are not financially sophisticated people. They don't have the convenience of a bank close by or a banker or an investment advisor that can help them in this area.

It's very convenient for them to have the payroll deduction and to have already the leg work done by those at Parker where we have given them the various investment options. It is just convenient.

I mean, they basically very simply said, if I had it in my paycheck I would be spending it on something else. In their thinking, when they look at an IRA, "Unless I have $2,000, I can't put it into a plan."

This allows them to have the choice of having 10 percent in our particular plan, deducted from their paycheck and put into a retirement plan.

Senator NICKLES. They can presently deduct 2 to 10 percent.

Ms. KUCHARSKI. Right.

Senator NICKLES. Does the company match that?

Ms. KUCHARSKI. We match 50 percent up to the employee's rate of contribution at 6. So we match a maximum of 3 percent and we do that in Parker stock, which is also very important to the employee.

I mean, there is a lot of Parker pride in Oklahoma and other locations where they are. They really do enjoy the benefit of the company match and becoming a Parker shareholder.

Senator NICKLES. Why not just set up a defined-contribution or defined benefit plan if you didn't have the section 401(k)'s?

Ms. KUCHARSKI. Well, unfortunately it really does not meet the needs of our particular industry because of the cyclical nature of the business.

As you know, a few years ago we had record profits and now we have record losses. We just really can't afford the fixed commitment of a defined benefit plan.

Additionally, the rate that we could put into the plan in the defined benefit would probably provide a very meager benefit to the employee as opposed to the section 401(k) plan which they can contribute to and, really, with the match, allows them to have a greater benefit and a much nicer retirement than had we been putting the same dollars into a defined benefit.

Senator NICKLES. Mr. Koch, you mentioned that you are using the section 401(k)'s basically to finance an ESOP?

Mr. KOCH. Yes, sir.

Senator NICKLES. I'm going to think out loud of all the prohibited transaction rules that deal with defined benefit plans and investing in those plans. I won't get into that now, but I'm sure you have probably looked at it.

Mr. KOCH. We have an outside appraiser, Senator, who is very competent.

Senator NICKLES. Again, I just throw that out for whatever it is worth. We have mentioned the complexity of pension systems. There are all kinds of restrictions on investing the funds.

I personally think that it's great. Kathy mentioned as far as employee ownership of company, and I commend you if you are able to do that and maintain the integrity of your company as a locally held and owned one.

Mr. KOCH. In an ongoing way. I mean, that's our whole purpose.

Senator NICKLES. Did your section 401(k) replace a defined-contribution plan?

Mr. KOCH. No, sir. We still have a pension plan.

Senator NICKLES. Defined benefit plan?

Mr. KOCH. Defined benefit pension plan, yes. The section 401(k) was implemented at the time the ESOP was implemented.

As part of the ESOP, we did take one of our pension plans—we had two—and folded it into the ESOP; but it is separate from the section 401(k) arrangement.

Senator NICKLES. I see. I am assuming that the employee puts in $1 and they receive 1 dollar's worth of stock?

Mr. KOCH. They receive a dollar-for-dollar match up to 5 percent of compensation. So if they put in 5 percent of compensation, the company gives them 5 percent.

Senator NICKLES. Is the company contribution in stock or cash?

Mr. KOCH. No, sir. It originally comes in in cash and our value is appraised annually. So immediately after the appraisal that cash is dumped in and stock is purchased.

Senator NICKLES. That cash is taken to purchase stock from the——

Mr. KOCH. Corporate stock.

Senator NICKLES [continuing]. Privately held shareholders.

Mr. KOCH. Selling shareholders; yes, sir.

Senator NICKLES. I am not going to say it's unique, but there are very few cases I have not heard of.

Mr. KOCH. There are very few. It is a wonderful way to maintain an independent newspaper because we have wonderful owners who want it to be that way.

Senator NICKLES. I commend you for it.

I will ask just one final question. We have not dealt much with this issue.

On the taxation of health and accident benefits, the proposal is do we want to tax a base amount—$25 or $30 on a family plan—or do we want to have a cap, not tax anything up to that cap.

Do any of the panelists have any comments on their preference in that field?

[No response.]

Senator NICKLES. If you don't, that's quite all right.

Thank you.

Mr. Naughton.

Mr. NAUGHTON. I will say, on behalf of the ACLI, that they just don't believe that a cap or a floor is really appropriate. The floor is clearly regressive. It is going to hit the lower income employees and the middle-income employees to a much greater extent than the higher income employees.

As far as a cap is concerned, that depends really on the amount of the cap and it depends upon where the individual is located and where he is working and his age and his sex, and so many other factors.

We think that there has to be a better way to raise revenue.

Senator NICKLES. Thank you very much for your comments.

On our next and final panel are Gerald Facciani, member of the Government Affairs Committee for the American Society of Pension Actuaries, and also James White who is president of Employer Plans Co. from Durant, OK.

Mr. Facciani, do you care to be first?

STATEMENTS OF GERALD D. FACCIANI, MEMBER, GOVERNMENT AFFAIRS COMMITTEE, REPRESENTING AMERICAN SOCIETY OF PENSION ACTUARIES; AND JAMES A. WHITE, PRESIDENT, EMPLOYER PLANS CO., INC.

Mr. FACCIANI. Senator, I appreciate the opportunity to testify before you on behalf of the American Society of Pension Actuaries, otherwise known as ASPA.

ASPA is a national professional society whose 2,000-plus members provide consulting, installation, administration and all too often, these days, termination services to over 30 percent of the country's qualified retirement and savings plans.

Our written testimony presents details regarding our position on the major tax policy issues outlined in Treasury II and expanded on by prior witnesses. In my oral testimony, I would like to expand on two tax proposal issues: namely, assets reversions and small business 401(k) plans.

The issues of asset reversions and single-employer termination insurance reforms comprise two branches of the same tree. Accelerating terminations of overfunded pension plans and the ongoing problem of companies dumping liabilities onto the PBGC in combination with an insufficient premium base has focused national attention on this issue.

Asset reversions have resulted not only from investment gains, but also from the funding maturity of older defined-benefit plans and a perceptible decrease in plan liberalizations. Treasury I and Treasury II, as well as the alternatives issued by the Joint Tax Committee last week would exact a 10- to 15-percent nondeductible excise tax on asset reversions.

We do not support these proposals.

Excess assets become available only after a plan has satisfied much more than the PBGC-guaranteed benefits. Thus, we have difficulty sympathizing with those who characterize all excess asset recovery as thievery.

The catastrophe, in our opinion, is not that excess assets are being recaptured. It is that the system is pushing sponsors to terminate pension plans.

Correcting the asset reversion problem involves demonstrating to current and proposed plan sponsors that Congress and the administration intend to maintain a climate friendly to defined-benefit pension plans.

Along this line, we offer the following proposals: One, establish a distinction between permissible asset withdrawal from an ongoing plan and asset reversion from one which is terminating. Any asset withdrawal would be repaid to the plan over time.

Two, establish a corridor between minimum and high plan asset balances allowing for withdrawals from an ongoing plan of amounts in excess of the amount necessary to 100 percent fund all accrued benefits.

Three, prohibit asset withdrawals from an ongoing plan if the sponsor is adjudged to be in imminent danger of bankruptcy.

Four, establish graded PBGC premiums which are related to the risk of potential liability to the PBGC.

Five, we support the establishment of a combined Labor Department/PBGC Committee to review and make recommendations on the issues of asset reversions and single-employer termination insurance reforms.

The advantages of our proposals are: First, except where sponsor bankruptcy is imminent these proposals would decouple the issues of excess asset recapture and plan termination; second, they would ensure maintenance of a high degree of security respecting benefits already accrued; third, they would greatly improve the fairness of the PBGC premium structure; and fourth, they would preclude attempts to recapture assets without plan termination where potential bankruptcy is imminent.

ASPA has prepared a detailed position on asset reversions, approved by our board 2 days ago, copies of which are available to you and your committee if desired.

The second issue on which I would like to focus deals with 401(k) plans. This committee has heard testimony from organizations that represent big business. You have heard testimony from the U.S. Small Business Administration that it's unsure of the impact of the 401(k) proposals on small business.

We have the opportunity to consult with small and large businesses. In our opinion, from the perspective of expanding coverage to the small business work force, the elimination of the 401(k) plans would be to put the final nail in the coffin of small business retirement plans.

Frankly, I don't care whether you call these plans savings plans or retirement plans. Do what you feel is necessary to the long-term social policy of the country, but don't eliminate 401(k) plans in their entirety.

To do so would, in my judgment, forfeit any possibility of increasing perceptibly plan coverage among small business.

The 401(k) plans are the best vehicles ever for small business and they provide what may be the only means to expand coverage in this sector. For example, my company employs 25 people in Cleveland. We have had a 401(k) plan for several years.

Until this year, we were unable to make any company contributions to the plan. In spite of this, over the last 2 years we have had 100-percent participation in the plan and the rate of deferral among the lower paid two-thirds was equal to the rate of deferral among the higher paid third, about 9 percent of pay.

I don't believe this is unusual among small-business 401(k) plans.

On behalf of all small businessmen, I urge you to consider the issue carefully before arriving at any conclusion. I would be glad to answer any question regarding the issues of asset reversion, single-employer termination, insurance reforms, or small-business 401(k) plans.

Thank you for the opportunity to appear before you.

[The prepared statement of Mr. Facciani follows:]

AMERICAN SOCIETY OF PENSION ACTUARIES (ASPA)

SUMMARY OF OCTOBER 1, 1985 TESTIMONY BEFORE THE SENATE LABOR SUBCOMMITTEE

ASPA generally supports the President's Tax Proposals.

However, ASPA does have two areas of great concern. One involves the effect which a high level of legislative activity is having on the stability of the private employee benefit system. In this area, we propose a solution: quinquennial implementation. With quinquennial implementation, legislation would proceed at its own pace. However, legislation requiring changes in plan design or administration would be implemented at five year intervals.

The other area involves a growing trend towards discrimination against small business. We review the factors behind this trend. We review the four key reasons why this trend must be brought to an end. The four are universal coverage, economic vitality, simplicity and fairness. We then list the changes which must be made in the Proposals, to eliminate this discrimination.

After covering these two areas of concern, we list a number of other changes which we believe will strengthen the President's Proposals. Among the more significant are:

> Indexation of this limit as well as the $200,000 limit on covered compensation.
>
> Rejection of the proposals to curtail profit-sharing deduction limitations.
>
> Rejection of the proposal to impose a 10% excise tax on asset reversions.
>
> Refinement of the proposed 125% coverage discrimination test.
>
> Refinement of the proposed new Employee Stock Ownership Trust provisions.

We are also quite concerned about the recent change in the President's Tax Proposals to provide for the elimination of §401(k) plans. We believe some adjustments in the rules governing these plans is appropriate, but strongly oppose their elimination. These plans are a very effective means of broadening retirement and savings protection. We have formulated our written testimony on §401(k) plans on the assumption that Congress will oppose the elimination of these plans, but will consider the modifications to them specified in the President's May, 1985 tax proposals.

The American Society of Pension Actuaries (ASPA) is a national professional society of about 2,000 members. Our members provide actuarial, consulting and administrative services to a significant number of private employee benefit programs in the United States. These include about 30% of the nation's qualified retirement plans.

In the main, we are pleased with the President's Tax Proposals, both generally and in their treatment of employee benefit plans. They recognize that the private pension system serves an important social purpose and should retain its present tax status. This is a welcome conclusion which we heartily endorse.

We do have three areas of great concern.

Our first concern involves the stability of the private employee benefit system. We believe this stability is threatened by the pattern of frequent legislative change which has emerged in recent years.

Our second concern involves a growing trend towards discrimination against small business in employee benefit legislation. This trend appears to reflect a bias against small business which is shared by employee benefit policymakers at both the Department of the Treasury and the Internal Revenue Service.

Our third concern involves the recent change in the President's Tax Proposals to provide for the elimination of §401(k) plans. We believe these plans are a very effective means of broadening retirement and savings protection.

In Part I. of our testimony, we address the question of stability and recommend a solution.

In Part II., we discuss discrimination against small business. We include a list of changes which would eliminate this discrimination.

In Part III., we list recommended additional modifications we believe would improve the President's Proposals.

I. STABILITY OF THE PRIVATE EMPLOYEE BENEFIT SYSTEM

ASPA is gravely concerned over the pace of legislative activity affecting employee benefits. Starting in 1981, we have seen four major acts, each with profound impact on employee benefit plans: ERTA in 1981, TEFRA in 1982 and DEFRA and REA in 1984.

Now we face another massive change with the President's Proposals.

But the worst part is that still more changes are waiting in the wings. These include social security integration, vesting, defined benefit asset reversion, and single employer plan termination insurance.

We face all of this at a time when we are still reeling from the effects of TEFRA, DEFRA and REA.

If anyone wanted to destroy the private system, and place the entire burden on social security, this might be the way to do it.

ASPA is convinced that deficit reduction pressures will interact with social justice pressures in maintaining the pace of activity at its current level. We do not believe this pace can be slowed.

However, there is an alternative which appears both feasible and effective. This alternative is quinquennial implementation.

With quinquennial implementation, employee benefit legislation could be enacted as frequently as necessary. But all legislation enacted in any five-year period would become effective one year after the end of the period. This rule would apply to all legislation requiring changes in plan design or administrative systems.

The Retirement Equity Act is effective in 1985. Hence, the next quinquennial implementation year might be 1990. All legislation enacted from 1985 through 1988 would be implemented in 1990. All legislation enacted from 1989 through 1993 would be implemented in 1995, and so forth.

Quinquennial implementation would end the need for continual plan amendment, employee reorientation and computer system redesign. It would mean that money now being spent on these efforts could be spent where it should be: to provide employee benefits.

Quinquennial implementation would not itself require enactment of any new law. It would simply require an agreement within Congress. This agreement would have to be clearly understood by the tax committees, the labor committees and their staffs.

ASPA recommends in the most vigorous terms possible that the Committee adopt the concept of quinquennial implementation now. We recommend that this approach be initiated with the employee benefit provisions of the President's Proposals.

II. DISCRIMINATION AGAINST SMALL BUSINESS

The appeal to self interest is the driving principle in the use of the tax code to encourage socially desirable employee benefit plans. The approach is to tell a firm's managers they can help themselves to favorable tax treatment only if they help their rank and file workers, too.

The approach has proven remarkably successful.

Unhappily, there is a growing bias among policymakers at Treasury and the Internal Revenue Service in favor of curtailing the effect of this approach in the case of smaller businesses. There appear to be two factors behind this bias. One, the inadequate return theory, is at least rational. The other, the greedy entrepreneur theory, is totally irrational, and unfortunately the more powerful of the two.

THE INADEQUATE RETURN

Tax favored treatment is often described as a "tax expenditure". Without the treatment in question, it would be possible either to lower tax rates in general, or to generate tax revenue for other purposes. Hence, the treatment means taxpayers in general are either paying extra taxes or foregoing other public expenditures.

If the tax favors helped only a firm's highly compensated employees, the tax expenditure would be viewed as undesirable. It is desirable only if it prompts the provision of benefits for rank and file workers. And, the price must be right. A certain amount of tax favoritism for highly compensated employees must buy at least a certain amount of coverage for rank and file employees.

Therein lies the rub.

Small firms have always had and will always have a higher ratio of chiefs to indians than the large ones. The extreme case is a solo entrepreneur. There are no indians at all. Almost as extreme is an entrepreneur with just one lower paid employee. Some policymakers feel these are firms where an expenditure for tax favored employee benefits is not justified.

THE GREEDY ENTREPRENEUR

Small entrepreneurs act out of self interest. So do the occupants of big business' executive suites. Our free enterprise system depends on it. The use of tax incentives to achieve social goals depends on it. Substitution of the word "greed" for the expression "self interest" is simply a resort to inflammatory pejoratives.

So, justification of discrimination against small business people because they are greedy is without rational basis. It overlooks the fact that all people are "greedy". It overlooks the fact the "greed" is what makes both free enterprise and our system of tax incentives workable.

"Greed" makes it important that there be controls surrounding all tax favors. It does not justify controls which discriminate against small businesses.

THE CASE AGAINST DISCRIMINATION

If one discards the greedy entrepreneur theory, just one question remains: do the arguments against discrimination outweigh the "inadequate return" argument? We believe they do. We see four important reasons why discrimination against small businesses should be vigorously avoided, in formulating and administering employee benefit rules. These are universal coverage, economic vitality, simplicity and fairness.

UNIVERSAL COVERAGE

Private employee benefit plans cannot play a meaningful role in our overall program of worker protection unless coverage is virtually universal. If any significant group of workers remains uncovered by private benefits, the pressure to do the job through public plans eventually proves overwhelming.

At present, there are private plan coverage gaps in each major area of protection: retirement, death, disability income and health care. In each case, there is a clear relationship between employer size and extent of coverage. The larger the firm, the greater the probability that its employees will have private protection. Statistics demonstrating this are readily available.

These statistics make it clear that virtually universal coverage requires significant improvements in the extent of coverage among small employers. The way to encourage employers to adopt and maintain plans is to strengthen incentives, not impose onerous burdens.

The consequence of onerous burdens is also demonstrable. TEFRA, enacted in 1982, reflects the greatest single instance of discrimination against small businesses in the history of legislation affecting employee benefits. I.R.S. statistics on new plan formation tell the story. In 1984, the first year TEFRA was fully effective, new retirement plan approvals dropped by 36%. Most observers believe this unprecedented reversal in trend is attributable almost entirely to TEFRA.

The consequence of an end to discrimination against small business will be increased private plan coverage. The consequence of increased private plan coverage will be reduced pressure to liberalize social security and related programs. Viewed in this light, the expenditure/return ratio is not unattractive. In fact, it becomes very attractive.

ECONOMIC VITALITY

The tax structure is just one factor a talented individual will examine, in considering the choice between entrepreneurship and the executive suite. But it is an important one. Employee benefit rules are just a small part of the tax structure. But they are material. They become particularly significant when the entrepreneur who has enjoyed a certain amount of success must decide whether to go on - or sell out.

To understand the chilling effect employee benefit rules can have on entrepreneurship, consider one aspect of the top-heavy plan rules added by TEFRA. Because of the way key employees are defined, it is possible for a firm to avoid top-heavy status by the simple act of selling out to a larger firm. The peculiar part is that the firms might have had identical retirement programs. They might decide to continue these programs after merger. Apart, one of them had a top-heavy plan. Together, neither does. Being top-heavy involves consequences which few large firms would willingly endure.

It would seem difficult for anyone to dispute the importance to our economy of maintaining a climate which encourages entrepreneurship. The problems which our established industries now face demonstrate how important it is that we develop new products and new services. Without a continuous flow of new industry, we shall find ourselves second class in the ranks of world citizens. As outsiders continue to challenge our established industries, we must continue to find new fields in which our superiority can be established.

Ownership interest is one of the most effective possible incentives to the development of new products and services. And entrepreneurship is the most complete form of ownership interest in existence.

Purely apart from the need for innovation, we need small business for the vitality it brings to our free market economy. As we permit our businesses to become bigger and bigger, and fewer and fewer, we find that the power of the free marketplace is muted by the bureaucratic structure of the large enterprise. We find administered prices. We find that wage rates are established either unilaterally, or by negotiation between a few large companies and a few large unions.

Some members of the Committee may question our use of this forum to discuss the importance of small business to our economy. The discussion should not have been necessary. However, this sense of importance seems to have been lost by the policymakers at Treasury responsible for legislative recommendations involving employee benefits. We feel certain it has not been lost by the Committee. We believe a reminder to the people at Treasury might be appropriate.

In assaying legislated tax discrimination against small business, it is worthwhile to remember the many items of inherent non-tax discrimination. Because a small business has fewer employees than a large one, its unit cost for professional advice is greater. It is unlikely to have in-house specialists. Its negotiating stance with insurance companies and investment managers is less attractive. These are all reasons why, if anything, one might justify tax discrimination in favor of small business.

SIMPLICITY

Simplicity is a key element of the President's Proposals. The desire for greater simplicity in our tax structure is one which is shared by every taxpaying citizen of this country. It is certainly one which is shared by every employee benefit plan sponsor and practitioner.

Even the most casual observer will recognize that the objective of simplicity is not fully realized in the President's Proposals. At certain points, the cause has suffered severe setbacks.

The correlation in the Proposals between complexity and discrimination against small business is notable. The greatest elements of complexity are associated either with new elements of discrimination or failure to eliminate existing ones.

Consider one flagrant example. In discussing limitations on benefits and contributions, the Proposals address the combined plan limit of IRC §415(e). They state that this limit "imposes a significant burden on employers and plans." They tell how the provision "requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored retirement plans." They state that "In most situations, the maintenance of both a defined contribution plan and a defined benefit plan would better serve the interests of employees generally."

Then, they recommend elimination of the noxious provision for all plans EXCEPT THOSE WHICH ARE TOP-HEAVY. As anyone active in the field knows, it is very difficult for smaller employers to have plans which are not top-heavy.

Nowhere is it explained why the small employer should have to suffer the "significant burden" from which the large employer is to be relieved. Nowhere is it explained why maintenance of both types of plan would not "better serve the interests of employees" of small employers as well as employees of large ones.

We have already pointed out the greater per-employee recordkeeping cost which a small firm must endure because of its size. To further unbalance the scales with this discriminatory approach to §415(e) is unconscionable.

We believe that as the Committee reviews our detailed recommendations, they will recognize additional instances where discrimination against small business has gone hand in hand with complexity.

Complexity is a powerful disincentive to new plan formation.

FAIRNESS

Suppose avoidance of discrimination could not be justified on the basis that avoidance helps promote universal coverage. Suppose it could not be justified on the basis that encouraging entrepreneurship helps maintain a vital economy. Suppose it could not be justified on the grounds of simplicity.

Suppose it were concluded, in short, that a tax expenditure/reward analysis does not justify tax favors for small businesses.

THERE WOULD STILL BE THE QUESTION OF FAIRNESS.

Under current law, for example, we tell the executive of a large company that his retirement benefits and allocations may be based on his full $300,000 salary. We tell the small entrepreneur earning the same salary that his covered pay for retirement plan purpose will be stopped out at $200,000. Is this fair?

The question takes on particular meaning when one considers that the large company has alternative and relatively painless methods for providing deferred compensation. Some of these alternatives are either unavailable or painful in the case of the small firm.

We are not suggesting, here, that it is either proper or improper to stop covered compensation at $200,000. We do suggest that in the interest of fairness, whatever rule applies should apply to all employees of all employers.

We might justify fairness on the basis of its importance as an integral part of the President's Proposals. The very word is part of the title.

We might justify fairness on the basis that fairness is the American way of doing things. Indeed, it is an important part of our society's morality.

We justify fairness on both of these grounds. But there is a third factor. Effective enforcement of a tax code in a free society is possible only if it is perceived as fair by the taxpayers.

This has often been pointed out. In fact, it is one of the tenets underlying the President's Proposals. But when this principle is articulated, the taxpayer in mind is usually the man in the street - the average citizen.

Very few observers realize how important it is that the small businessman perceive the code as fair. In the highly complex area of small business tax administration, voluntary compliance grounded on a perception of fairness becomes critical.

ASPA RECOMMENDATIONS TO ELIMINATE DISCRIMINATION

We urge the Committee to consider these amendments to the President's Proposals. Some are changes, some are additions, some are deletions. We make these recommendations in the interest of eliminating discrimination against small employers:

LIMITATIONS ON BENEFITS AND CONTRIBUTIONS

The Proposals call for a 10% excise tax on distributions which exceed $112,500 per year for any individual. The dollar amount is to be indexed starting in 1988. We commend this proposal as a means of accomplishing all of what §415 was designed to accomplish - and more.

But, the Proposals do not go far enough. Having offered this simplification, they should have proposed eliminating all of §415, not just §415(e). Perhaps the 10% rate is too low. Perhaps the $112,500 amount is too low. Indeed, we believe it might more sensibly be initialized at $150,000.

The point is that the proposal is a simple and effective way to control excessive qualified plan funding - there is no incentive to fund a benefit which is going to be subject to a stiff excise tax. It is a simple and effective way to control undue postponement of benefit commencement date. Extreme postponement simply means more of the benefit is subject to the tax.

Having established this simple control, we should eliminate the controls no longer needed - completely.

If the Committee should conclude that eliminating all of §415 is not desirable, the element of discrimination surrounding §415(e) should certainly be avoided. Either §415(e) should be eliminated for all plans or it should be retained for all plans. And the discrimination of current law should be repealed. Under this existing discriminatory provision, §415(e) is more restrictive for some top-heavy plans than for non top-heavy plans in general.

We recommend phased, but complete repeal of §415. In the meantime, we recommend immediate repeal of §415(e) for all plans.

The Proposals include a more restrictive approach to the §415 dollar limitation applicable to defined benefit plans. The proposal is that the full dollar limit be reduced for fewer than ten years of participation rather than ten years of service.

This proposal reflects bias against small entrepreneurs. It also reflects a total lack of understanding of the problems faced by new start-up businesses. There is reference to a need to prevent "the key employee of an employer, typically a small employer, from delaying the establishment of a defined benefit plan until such employee is close to retirement."

Small business formation is not always a smooth and orderly thing. It often ends in bankruptcy. When it is successful, it often involves several years of near failure and then, finally, dramatic success.

That knave who the Treasury policymakers believe has been craftily doing his employees out of pensions probably hadn't even been thinking about pensions. He was probably too concerned with meeting tomorrow's payroll.

As part of our effort to encourage the formation of new business entities, we must appreciate and work with this famine-and-then-feast pattern. We must maintain a tax structure which acknowledges existence of the pattern.

If it is not determined that §415 should be repealed completely, the approach to the defined benefit dollar maximum should be retained in its current form.

We recommend that the proposal to count participation rather than service be rejected.

RETIREMENT PLAN DEDUCTION LIMITATIONS

The Proposals would amend the 25% combined plan deduction limitations of §404(a)(7). At present, the limitations apply only to combinations involving profit sharing plans. The proposed application would involve all defined-benefit/defined-contribution combinations.

On the surface, this proposal appears innocuous. After all, defined contribution pension plans have a great deal in common with profit sharing plans. Actually, this proposal reflects the same objectives as the proposal to change the basis for applying certain §415 limits from service to participation.

That objective is to clip the wings of the entrepreneur who does not establish a retirement program until late in his career. Again, there is a lack of understanding of the famine-and-then-feast pattern of new business start-up.

We recommend that the 25% limitation of §404(a)(7) be entirely repealed. The limitations on contributions and benefits (§415 or its successor) provide all the controls needed.

The uninitiated observer might wonder why so much fuss is being made over a limit as high as 25%. For the individual fairly close to retirement age when a new plan is made effective, it is not difficult to exceed this limit. This is the case even with a plan providing modest benefits. We would be happy to furnish the Committee with numerical illustrations, if desired.

DISCRIMINATION AGAINST RANK AND FILE EMPLOYEES

ASPA applauds the concept of a bright-line coverage discrimination test.

However, the definition of the prohibited group involves elements of discrimination against small business. First, it automatically includes (for practical purposes) the highest paid three employees of the employer. Clearly, this is an inconsequential inclusion for a large company. It is not necessarily inconsequential for a smaller group.

Second, the definition includes 1% owners. An individual might own, say, $100,000 in a large company and still avoid 1% ownership. The answer is different for the person with a $100,000 interest in a small start-up enterprise.

We recommend that the highest-paid-3 category be removed from the prohibited group definition. We recommend, as well that consideration be given to elimination of the 1% owner category. The top 10% category appears to provide all the control that is needed. This is another case where simplification and the elimination of bias go hand in hand.

A number of benefit forms involve a proposed "concentration test." This is a carryover from current law. It applies to legal service, cafeteria, educational assistance and dependent care plans. Under the Proposals, it may be intended that the concentration test is to apply to all non-insurance-type fringe benefits.

Under the proposed new concentration test, one examines the highest paid 20 members of the prohibited group. If costs or benefits for these highest paid 20 exceed 25% of costs or benefits for all participants, the test is flunked and the plan is discriminatory. By looking at an absolute number, 20, the test discriminates blatantly against small enterprises. This biased test, like many other elements of bias, involves a high degree of complexity.

We recommend that all use of the concentration test be abandoned.

We have already referred to the $200,000 limitation on compensation applicable to participants in top-heavy plans. The President's Proposals make no reference to this limitation.

We recommend that the $200,000 limitation be addressed in any comprehensive tax reform package. Either it should be extended to all plans or it should be repealed.

RETIREMENT PLAN BENEFIT DISTRIBUTION RULES

The Proposals are laudable in suggesting elimination of bias respecting premature distributions.

However, they are silent on the bias under current law respecting required distributions.

At present, a 5% owner must commence receipt of benefits upon attainment of age 70½, whether or not he has retired. This requirement should apply to everyone, or no one.

We recommend that in view of the proposed excise tax on excessive annual distributions, a fixed mandatory starting age be viewed as unnecessary. Should the Committee feel retention of some maximum age is desirable, we are prepared with alternative suggestions.

EMPLOYEE STOCK OWNERSHIP TRUSTS

The President's Proposals are commendable in their general treatment of leveraged ESOP's. ASPA, too, believes that employee stock ownership is desirable, but should not be mixed into retirement security.

But here, again, there is bias against small business. The proposed new vehicle is to be available only to firms with at least 15 employees.

We recommend that this 15 employee restriction be rejected.

VESTING AND INTEGRATION

The provisions of §416 discriminate against small employers respecting vesting requirements and social security integration. In both cases, the discrimination is accomplished by imposing special rules on top-heavy plans. We have already remarked on the fact that most small employers find they are unable to escape top-heavy status.

The special social security integration requirements take the form of minimum benefit rules.

In both of these areas, the special rules were established with the objective of controlling perceived "greed" on the part of the small employers.

Vesting and integration are both areas where the only rational approach is to start with a definition of national objectives. Once the objectives are defined, sensible rule-making becomes possible. When the problem is approached in this way, the need for rules which are consistent for all plans becomes vividly apparent. A worker's needs are not affected by whether he works for a small company or a large one.

ASPA has a legislative outline in which we discuss both vesting and social security integration. Our proposed approach to social security integration, in particular, is developed in some detail. We would be pleased to make this outline available to the Committee.

For the moment, we believe the consensus will be that vesting and integration should not be addressed during the Committee's review of the President's Proposals.

III. OTHER AREAS OF CONCERN

ASPA has identified other areas where we believe the President's Proposals would benefit by amendment. We urge the Committee to consider each of these other recommendations:

DISCRIMINATION AGAINST RANK AND FILE EMPLOYEES

In applying the Proposal's 125% coverage test, an employee who fails to make a mandatory employee contribution is treated as not covered. However, if the contribution is converted to a cafeteria plan salary reduction, the same employee is treated as covered. We recommend that an employee who failed to make a mandatory employee contribution nevertheless be treated as covered. We make this recommendation for both retirement and welfare plans.

In applying the 125% coverage test to a retirement plan, it is proposed that, in certain cases, employees with fewer than two years be excludable. This is the proposal articulated for plans, other than cash/deferred arrangements, which provide full and immediate vesting. The two year exclusion is inconsistent with the three year eligibility rule of §410. The three year rule has been useful in helping to encourage employers to adopt full vesting. For the moment, we believe it should be retained. We recommend that the 125% test for retirement plans be brought into line with the eligibility rules of current law.

The proposed 125% rule needs modification in its application to welfare plans which permit, for example, optional forms of health coverage. These might be hi-option/lo-option arrangements. They might be arrangements made necessary by the HMO Act. Under certain circumstances, this Act requires an employer to contribute as much to the cost of optional HMO coverage as he is spending on the conventional arrangement.

We recommend that the employer be permitted to combine options, for the 125% test, wherever the employer's contribution is the same for each option. For this purpose, we recommend that an employee's cafeteria plan salary reduction contribution not be deemed an employer contribution.

Respecting reimbursement accounts, we believe we are missing an opportunity for health care cost control through plan design. We recommend that modest health care reimbursement accounts be permitted which are not subject to the use-it-or-lose-it rule. We recommend that these same modest accounts be exempted from the 125% usage test.

VOLUNTARY PERSONAL SAVINGS

ASPA is in sympathy with the need to curtail the use of tax favored savings for purposes other than they provision of retirement income. The President's Proposals relative to cash/deferred §401(k) plans will slow the development of these plans. Provided everyone recognizes this, the Committee may not find this slowing down objectionable. There are certain aspects of the cash/deferred proposals which do deserve revision, however.

First, the $8,000 limit is much too low. We recommend a $15,000 annual limit for cash-option deferrals.

Next, we recommend that both the contribution limit and the $200,000 covered compensation limit be indexed to inflation.

Next, we believe the upper/lower ratios of §401(k)(3) should be simplified. We recommend a flat two-times rule. Under existing law, the maximum permissible percentage is a permissible average. Under the Proposals, this maximum would have to be satisfied by each member of the upper group, individually. This is a significant tightening of the rules. Given this tightening, we believe our flat two-times recommendation is reasonable.

Consistent with our flat two-times recommendation, we recommend a flat one-and-one-half-times rule for employer matching contributions which do not satisfy the §401(k)(2) restrictions. Under the Proposals, the supposedly more restrictive rule for employer contributions will sometimes be more liberal. Fixing this inconsistency could involve a complex requirement. Our flat ratio recommendations avoid this problem and are generally simpler.

Next we recommend that recharacterization of an employee's salary reduction contribution into a non-deductible contribution be permitted as a corrective procedure. The I.R.S. seems to believe this recharacterization privilege would lead to "audit roulette." We believe this problem can be controlled through a tight time limit (perhaps one month) on the period after year-end during which recharacterization may take place.

In evaluating the rules on tax favored personal savings, we recommend that the Committee re-examine the rules on tax-sheltered annuities under §403(b) and deferred compensation under §457. It is not readily apparent why anti-discrimination rules should not be extended to these arrangements.

RETIREMENT PLAN BENEFIT DISTRIBUTION RULES

The proposed changes to exclusion ratio rules deserve rethinking. It is difficult to be sympathetic with the proposition that quinquennial grouping of recovery periods is necessary for administrative simplicity.

We find it objectionable, too, that the taxable portion of a monthly retirement check should increase if the recipient should outlive his recovery period. On the limited issue of calculation and application of exclusion ratios, we recommend that the Proposals be rejected. We do find the proposal to eliminate the three-year recovery rule entirely acceptable.

QUALIFIED RETIREMENT PLAN DEDUCTION LIMITATIONS

The Proposals would repeal profit-sharing credit carryover provisions for plans other than "retirement-type" plans. Retirement-type plans are defined in a manner which virtually precludes utilization of the exception. We believe credit carryover provisions serve a socially useful purpose. They permit an employer who must curtail contributions for business reasons to make it up to his employees in later years.

The proposal that profit-sharing limitations be applied on an individual basis should be tabled, pending a full review of social security integration.

We recommend that both the proposed credit carryover repeal and the proposed individual application of the 15% limitation be rejected.

IN-SERVICE DISTRIBUTIONS FROM TAX-SHELTERED ANNUITIES

New in-service distribution restrictions are proposed for tax-sheltered annuities established under §403(b). Under these rules, in-service distributions would be permitted, but only after age 59½.

We believe a consistent set of rules should apply to all work-related voluntary personal savings plans. If in-service distributions are to be precluded entirely for salary reduction contributions under §401(k), they should be precluded as well for similar contributions under §403(b) and §457 arrangements.

We recommend that an attempt be made to establish a uniform rule on in-service distributions from work-related voluntary personal savings plans.

ASSET REVERSION UPON PLAN TERMINATION

The Proposals would impose a 10% excise tax on asset reversions upon pension plan termination.

The question of asset reversion upon plan termination is difficult and highly charged. Some observers believe reversion should not be permitted al all. Others believe the problem of inappropriate termination should be attacked by permitting limited reversion from ongoing plans. This limited reversion provision might be coupled with a provision for a graded PBGC premium structure. In this way, the promise of a higher PBGC premium might serve as a disincentive to asset recapture.

In any event, the proposed 10% tax as an offset to the advantage gained through tax-exempt growth is entirely too inaccurate a form of justice. In some cases, it would be overkill. In others, it would be inadequate.

We recommend that the Proposal for a 10% tax on reversions be rejected. We believe the question of asset reversion deserves special attention and should not be made part of a general tax reform package.

ASPA is currently preparing a legislative recommendation on the issue of asset reversion. We expect to make it available to the Committee as soon as it is completed.

EMPLOYEE STOCK OWNERSHIP TRUSTS

The President's Proposals respecting ESOTs are commendable. We do suggest certain refinements.

First, we believe age, service and class exclusions should be permitted. We recommend that the rules and coverage discrimination tests here be the same as those which apply to retirement plans - with a waiting period not to exceed one year.

Next, we recommend that the $50,000 cap on covered compensation be indexed to inflation.

Next, we recommend that dividends and the passed through tax savings on dividend deductions both be eligible for rollover. This rollover would permit the participant to postpone what would otherwise be a taxable event. The vehicle receiving the rollover could be either an IRA or a qualified retirement plan. We recommend this treatment for dividends on allocated stock retained in the ESOT as well as dividends distributed from stock not yet allocated. This provision would offer a useful incentive for additional personal retirement savings.

Next, we recommend consideration of a pass through of all voting rights relative to unallocated shares. The Proposals include only a limited pass through.

Finally, we recommend that securities law be amended at the same time the new ESOT provisions are incorporated into the tax code. We recommend that the same registration exemptions now applicable to qualified plans be extended to these new programs.

* * * * * *

ASPA is pleased at the opportunity to present its views to the Committee. We are eager to help the Committee and its staff in every way possible, as it pursues its consideration of the President's Proposals. We would welcome requests for assistance at any time.

Respectfully submitted by:

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ASSET REVERSIONS FROM DEFINED BENEFIT PENSION PLANS

PROPOSALS OF THE AMERICAN SOCIETY OF PENSION ACTUARIES

1. BACKGROUND

INTRODUCTION

Asset reversions from defined benefit pension plans constitute one of the most charged employee benefit issues on today's legislative agenda. Senators and Representatives who ordinarily show no interest in employee benefits spring to attention when asset reversion is mentioned.

Under today's rules, asset reversion takes place when a pension plan sponsor "terminates" his plan and finds that his pension fund exceeds the termination solvency level. When this happens, the excess often reverts to the plan sponsor.

Attitudes respecting these reversions are never casual. At one extreme, some viewers characterize any reversion as thievery. The corporate employer is robbing from its current and future retirees. At the other extreme, some characterize any attempt to control reversion as ex post facto confiscation.

TERMINATION SOLVENCY LEVEL

Our focus, here, is on defined benefit pension plans other than collectively bargained multi-employer plans.

Suppose a plan is being terminated and annuities are to be purchased for every participant. Purchases might be from a commercial insurer or they might be from the Pension Benefit Guaranty Corporation (PBGC). The annuity amount would equal the vested benefit for each retired or otherwise inactive former participant. It would equal the full accrued benefit whether or not vested for each active participant. Assets required to purchase all such annuities for the plan constitute the "termination solvency level" of assets. A plan whose assets equal or exceed this level is said to have achieved "full termination solvency". Assets which exceed the termination solvency level are "excess assets".

The significance of these definitions bears emphasis. Until all promises to all active and former participants have been fully guaranteed, there can be no excess assets subject to reversion.

It is worth noting that full termination solvency often requires a higher level of assets than PBGC sufficiency. A plan achieves PBGC sufficiency when its assets are sufficient to guarantee benefits insured by the PBGC. These insured benefits exclude non-vested accrued benefits, and benefits which exceed the maximum insurable limits. Even vested benefits not exceeding this limit may escape protection. This is because protection for benefits under new plans or amendments is not immediate, but is phased in over a five-year period.

PSEUDO TERMINATION

Under current law, excess assets cannot be recovered unless the plan is terminated. But sometimes, the "termination" is not really a termination. The terminated plan is simply replaced by an identical new plan which picks up where the old one left off. This termination/replacement transaction, as a means of recovering excess assets, currently has regulatory approval. See PBGC news release 84-23.

Another form of pseudo termination is a spin-off/termination transaction. In this transaction, one plan is split into two. Active participants are included in one of the two. Retired, and vested former employees are included in the other. Excess assets go with the retired-inactive plan which is then terminated. This, too, is deemed acceptable under the guidelines reported in the PBGC news release.

PREVALENCE OF PLANS WITH EXCESS ASSETS

Three factors have contributed to the increasing prevalence of plans containing excess assets.

First, in terms of real investment rates of return, the recent past has seen record-setting highs. We define real rates as the excess of nominal rates over inflation rates.

For the moment, inflation is being contained. But one tool used in this containment has been tight money. This tight money policy has helped push interest rates up and inflation rates down. The result has been real rates of return well in excess of those predicted by plan sponsors and their actuaries.

Second, many plans established in the 1940's and 1950's are now reaching funding maturity. The job of funding past service benefits is nearly completed. Assets in these plans have reached and sometimes passed termination solvency levels.

Third, we have witnessed a fall-off in plan liberalizations. Heavily funded plans, which might normally have taken on additional liabilities through benefit increases, are not undergoing improvements.

MOTIVATION TO CAPTURE EXCESS ASSETS

There are several factors motivating plan sponsors to reach out and attempt to recover excess assets.

First, tight money has made corporate borrowing more difficult. Financial executives see recovery of pension assets as an attractive alternative to borrowing.

This money-raising device is especially popular among "work-out artists" - consultants brought in to straighten out troubled enterprises.

Second, the existence of a plan with excess assets can be undesirable "shark-bait" to companies interested in unfriendly takeovers. Excess assets, still in the pension fund, are not always fully reflected in the takeover costs for an acquisition-minded predator. These assets can lead to a special kind of arbitrage. Buy a company, terminate its pension plan, take excess assets into its corporate treasury, and then sell it for an increased price.

Third, there is a general sense that the climate has become unfriendly to defined benefit pension plans. This consensus is fed by talk of increased governmental regulation and new financial accounting standards. The American Society of Pension Actuaries (ASPA) has commented often on this unfriendly climate, the need to make it friendlier, and how this might be accomplished.

The wisdom among some financial executives has been that defined benefit plans should be abandoned and replaced with defined contribution arrangements.

2. ASPA LEGISLATIVE PROPOSALS

ASSET REVERSIONS

ASPA is a national professional society of about 2,000 members. Our members provide actuarial, consulting and administrative services to about 30% of the nation's qualified retirement plans.

Given this degree of involvement, we are vitally concerned with the related problems of asset reversion and plan termination.

We have difficulty sympathizing with those who characterize all excess asset recovery as "thievery".

The catastrophe, in our opinion, is not that excess assets are being recaptured. It is that the system is pushing sponsors to terminate pension plans.

Correcting matters goes beyond a solution to the asset reversion problem. It involves demonstrating to current and proposed plan sponsors that we intend to maintain a climate not unfriendly to defined benefit pension plans. But, a rational approach to the asset reversion problem is certainly one part of the solution.

We make these proposals:

1) Establish a distinction between permissible asset withdrawal from an ongoing plan, and asset reversion from one which is terminating.

2) Establish a corridor between minimum and high plan asset balances. Make asset withdrawals conditionally permissible, even while a plan is ongoing, to the extent asset balances do not fall below the lower corridor boundary. The condition involves the absence of imminent bankruptcy, described at Item 3.

   a) Define the "lower corridor boundary" as the termination solvency level.

b) Define the "upper corridor boundary" as 150% of the termination solvency level.

3) Prohibit any asset withdrawal from an ongoing plan, if the sponsor is adjudged to be "in imminent danger of bankruptcy."

a) Administer this prohibition by requiring that a plan sponsor give participants and the Department of Labor six months' advance notice of intent to withdraw assets.

b) Establish machinery by which plan participants or the Department of Labor can obtain a judicial determination during this six month period, if appropriate, that the sponsor is in imminent danger of bankruptcy.

4) Establish graded PBGC premiums which are highest when the termination solvency level exceeds asset levels by the greatest amount, ranging down to zero at the upper corridor boundary.

a) Accomplish this by applying a fixed premium rate to the amount, if any, by which the upper corridor boundary exceeds 100% of assets.

b) Later, we discuss possible refinements under which the 100% factor is replaced by factors which depend on the nature of assets.

FUNDING STANDARDS

Current funding standards make it difficult for a plan sponsor to control the flow of contributions so that assets are maintained at exactly the termination solvency level. ASPA believes that with the proposed graded PBGC premium structure in place, it will become both feasible and desirable to permit this control.

Certain other changes in funding standards are necessary, to integrate standards with our asset reversion proposals.

We make these proposals:

1) Amend provisions of Internal Revenue Code §412(g), relative to the alternative minimum funding standard.

a) Provide that use of the standard is not contingent on use of a funding method "that requires contributions in all years not less than those required under the entry age normal funding method".

b) Provide that the charge under §412(g)(2)(A) is simply the amount (if any) by which the year-end termination solvency level exceeds assets.

2) Amend provisions of Internal Revenue Code §412(b)(2) relative to charges to the basic funding standard account.

   a) Provide that any credit established upon changing from the alternative to the basic standard will be amortized over 30 rather than 5 years.

   b) Add, to the list of charges, a charge equal to the amount of any asset withdrawal.

ADVANTAGES

We believe our proposals offer these advantages:

1) Except where sponsor bankruptcy is imminent, they would decouple the issues of excess asset recapture and plan termination. Hence, they would eliminate a vexing motivation for defined benefit plan sponsors to terminate their plans.

2) They would permit sponsors to avoid funding beyond termination solvency levels. Hence, they would eliminate a vexing motivation to attempt slowdown of asset buildup at levels far below full solvency.

3) They would insure maintenance of a high degree of security respecting benefits already accrued.

4) They would greatly improve the fairness of the PBGC premium structure. Sponsors willing to maintain high funding levels would avoid premiums for an exposure they do not present.

5) They would preclude attempts to recapture assets without plan termination where potential bankruptcy is imminent. Hence, they would avoid the potential scenario of asset reversion, followed by market value erosion of remaining assets, followed by sponsor bankruptcy.

3. COMPETING PROPOSALS

ALTERNATIVE PROVISIONS PROPOSED

A number of alternatives have been proposed, by others, to deal with the asset reversion issue. In general, these alternatives include one or more of these provisions:

a) Excise Taxes - An excise tax would be imposed on any amount returned to the plan sponsor.

b) Restrictions on Reversions - Either reversions would be prohibited altogether, or they would only be permitted after certain additional benefit provisions had been incorporated.

c) Prohibitions on Pseudo Terminations - Termination/replacement transactions and spin-off/termination transactions would be distinguished from bona fide plan terminations. Transactions in the first category would be outlawed. Bona fide terminations would continue to be permitted.

d) Contingency Fund Requirements - These are generally incorporated into proposals which, like our own, would permit withdrawals without any pretense of plan termination. However, they would require either the purchase of annuity contracts to cover accrued benefits, or the maintenance of a contingency fund to protect against the possibility of market value erosion.

FUNDING DISINCENTIVES

An objectionable feature shared by provisions in the first two categories is that they would discourage funding. They would encourage attempts, responsible or otherwise, to fund plans at levels which are unacceptably low. Consider the mature plan approaching full termination solvency. Under current funding standards, it is almost impossible to maintain assets at exactly the termination solvency level. Suppose we tell the sponsor that upon termination he will lose, or be surtaxed on, any excess assets. The sponsor who wishes to avoid this possible consequence will have an incentive to keep assets well below the termination solvency level. This is inconsistent with a national goal which calls for current funding of pension promises.

EX POST FACTO LEGISLATION

Proposals in these first two categories share a second objectionable feature. It is a simple issue of fair play. Unless the new prohibition applied only to future accumulations, there would be an unfortunate aspect of retroactivity. Plan sponsors would find they had made contributions on the basis of one set of rules only to discover that the rules have been changed - retroactively. There is considerable precedent for retroactivity, given persuasive social needs. Nevertheless, we believe retroactivity should always be treated as a device of last resort.

In matters of pension reform, especially, we seem to have lost sight of the basically abhorrent character of retroactive rules changes. Our casual approach to retroactivity is already taking its toll. We find employers increasingly reluctant to venture into new retirement funding arrangements. They explain they just cannot be sure what new rules might be applied retroactively, to make them wish they had not moved ahead.

EXCISE TAXES

Excise taxes are often justified on the basis that they help recover a tax expenditure which, in retrospect, was not appropriate. Assets were enjoying growth in a tax exempt fund in the expectation that they would be used for retirement income. A consequence of reversion is that they will not be used for this purpose.

In a true termination, without a replacement, this position has merit. However, even here, a flat excise tax is too rough a form of justice. The excise tax suggested in the President's Tax Reform Proposals is 10%. For excess assets which have been resident in a tax-sheltered trust over a long period of time, this is a woefully inadequate adjustment. For excesses which were built up more quickly, it is far too severe.

Consider excess asset recovery without a bona fide termination. Here, an excise tax as a "correction" of an inappropriate tax shelter introduces a new element of inconsistency. Surplus assets which are withdrawn would be subject to taxation. Surplus assets which are permitted to remain in the ongoing fund would not. As long as the sponsor has future contribution requirements, these surpluses will benefit him whether or not they are temporarily removed and later re-contributed. If withdrawn, they will be used to make future contributions. If not withdrawn, the will be used to reduce future contributions. The financial impact is the same either way.

INAPPROPRIATENESS OF REVERSION RESTRICTIONS

Restrictions on reversions reflect a failure to focus on national objectives. Suppose a responsible employer has maintained a plan providing benefits entirely consistent with these objectives. Suppose this plan must be terminated - for a totally legitimate reason. If excess assets cannot revert to the employer, they will presumably be used to increase benefits. At this point, participants will be eligible for benefits which exceed those dictated by national goals.

It is not enough to analyze matters in terms of an employer and his employees competing for the same resources. We believe our society should not be casual about exceeding its goals in any area - while other goals remain unsatisfied.

SOCIAL POLICY AND PSEUDO TERMINATIONS

We find a prohibition limited to pseudo terminations objectionable as a matter of social policy. Consider two employers, similarly situated in every respect. Each is terminating a defined benefit plan involving excess assets. The first provides his employees with nothing in replacement. The second establishes a successor retirement plan, which satisfies objectives similar to those of the terminated plan. The second employer has continued to accept responsibility for the provision of retirement benefits. The first has walked away from this responsibility. Should we treat the second more severely than the first? It seems clear to us that we should not. Yet, this would be the result of prohibitions related to pseudo terminations.

CONTINGENCY FUND REQUIREMENTS

We find those alternatives permitting reversions only if annuities are purchased, or contingency funds maintained, far less objectionable than the others. Like our own proposals, they free asset recapture from the requirement of plan termination - real or pseudo. Nevertheless, the annuity-or-contingency-fund requirement will not always present a happy choice.

Consider the annuity option. We believe a way should be found to accomplish our nation's objectives and still offer plan sponsors a choice of funding media.

Consider the contingency fund option. The sponsor motivated to recover excess assets may well find complete termination preferable to a sizable contingency fund.

The objectives of the contingency fund would be to deal with potential erosion in market values. Our proposals attack this problem with a graded PBGC premium structure. We believe our proposals are preferable.

4. AN OBJECTION TO OUR PROPOSALS - THE PROBLEM OF PAY INCREASES

THE PROBLEM

Some observers will object to our proposals on grounds related to future pay increases. They will point out that accrued benefits calculated on a termination solvency basis do not reflect such increases. Consider a plan which defines accrued benefits using a fractional rule - benefits accrue ratably over participation. Suppose this plan relates benefits to final average pay. For the participant who remains until retirement, benefits will be related to pay averaged over the final years before retirement. Looking backwards from retirement date, one could determine how much of this final benefit would have accrued at any point in the participant's history. Looking forward from the same earlier point, this precision would be impossible. In fact, the plan's definition of accrued benefit, applicable at this earlier point, will almost certainly ignore the possibility of later pay increases.

Observers raising this objection will suggest that funding targets should exceed accrued benefit values whenever a participant is several pay increases away from retirement. In the viewpoint of these observers, accepting anything less means relying too heavily on the sponsor's ability to make future contributions. As future pay increases occur, the sponsor will have to fund both future accruals and automatic increases in past accruals. These automatic increases will be related to the moving nature of the participant's final average pay.

We believe modifying our proposals to accommodate this viewpoint would seriously diminish their advantages. We believe this viewpoint overlooks a number of factors.

THE NATURE OF THE PROMISE

A sponsor rarely makes any commitment to continue accruing benefits or to continue adjusting current accruals for future pay increases. Even where the plan is the subject of a labor contract, the commitment rarely extends beyond two or three years - not long enough to profoundly alter pay averages. The sponsor may find it highly advantageous from an employee relations standpoint to continue accruals. The sponsor might be well-advised to set funding targets voluntarily which are considerably in excess of accrued benefit values. But these are the sponsor's problems.

The only promise the sponsor has made to participants involves benefits already accrued. We suggest that this promise marks the limit on funding targets which society should impose on the sponsor.

FINAL PAY PLANS VS. FLAT DOLLAR PLANS

There is an inconsistency between the approach these observers would require and the approach permitted where benefits are not explicitly related to pay.

Plans in the latter category generally cover groups where employee-by-employee pay differences are not great. With these groups, it is possible to relate a participant's retirement income rationally to his active wage without explicitly referring to that active wage. Nevertheless, whether explicit or implicit, the relationship is there. Any suggestion that fixed dollar plans will be able to avoid continual amendment, as wage rates increase, is a flight from reality. But, few observers have seriously suggested that sponsors should be required to fund towards targets which anticipate these amendments. Indeed, under current law, any such funding would be on a non-deductible basis.

So, a pay-related plan sponsor always has two options: amend and freeze accruals or fail to amend and let them float. A fixed dollar plan sponsor always has two options: fail to amend and let accrual rates stay frozen, or amend them up. In each case, one option works by default, one requires sponsor action. In each case, continually adjusted rates will be necessary to maintain the plan as an effective compensation tool. In each case, the only promise to participants is to provide what has already accrued without recognizing future wage increases. In each case, a prudent approach to anticipation of future increases should remain a matter for voluntary planning.

FINAL PAY PLANS VS. CAREER PAY PLANS

The inconsistency also becomes apparent when final pay and career pay plans are compared. Suppose a career pay plan relates benefits to pay averaged over a participant's entire career beginning with the plan's "key date". Suppose this plan goes on to provide that, in any event, a participant's pay will be averaged over a period not shorter than 5 years. Suppose the key date is established initially as the plan's effective date. Finally, suppose the plan is amended every 5 years, redefining the key date by moving it forward exactly 5 years.

In operation, this plan will work exactly like a final 5 year average pay plan. Yet, those who would mandate funding targets which exceed accrued benefits would treat the two plans quite differently.

THE PROPER LIMITS OF LEGISLATIVE AND REGULATORY CONTROL

We believe two requirements are vital:

- A sponsor should be required to take steps which will adequately secure promises already made.
- The sponsor should be required to inform participants regarding decision on funding beyond these promises.

Our proposals are compatible with both requirements.

To summarize, some observers would require higher funding targets on the basis that they are needed for future accrued benefit increases. We agree it is often rational to adopt these higher targets. As practitioners, we often counsel our clients to adopt them. But we cannot agree they should be required. Requiring them is analogous to requiring that the employer who has no plan at all must set money aside anyway - to be utilized when he finally adopts one.

5. OTHER OBJECTIONS TO OUR PROPOSALS

THE PROBLEM WITH LEVEL CONTRIBUTION FUNDING

Some observers will object to our proposals on grounds which go beyond realistic anticipation of future pay increases. Even where future pay increases are not anticipated, there is an argument for target funding levels which exceed accrued benefits. These higher targets are a function of actuarial cost methods developing level annual contributions. An accumulation of these contributions will characteristically exceed the value of accrued benefits. It should be pointed out to these observers that other cost methods, considered totally rational by many actuaries, do not include this characteristic. These are commonly classified as accrued benefit or unit credit cost methods.

These observers should also be reminded of the arguments we make in discussing projected future pay. The sponsor might rationally opt for a level contribution actuarial cost method. Until assets equal a level which will secure promises, this cost method, once adopted, may reasonably govern the manner in which funding standards are applied. But once promises are secured, continued adherence to any funding method which goes beyond maintaining this secured status should be a totally voluntary affair.

THE PROBLEM OF MARKET VALUE FLUCTUATIONS

Probably the most common objection to our proposals will involve the possible erosion of market values. Suppose assets are withdrawn to the point that remaining assets at market value just equal the lower corridor boundary.

Suppose remaining assets suffer severe erosion of market values. The security of promised benefits is no longer guaranteed by fund assets.

All of this is true. It is the very reason for our proposed graded PBGC premium.

The sponsor who permits asset levels to fall back to the lower corridor boundary will constitute a more serious potential liability to the PBGC. And, this sponsor will be asked to pay a greater premium. The sponsor willing to maintain levels at the upper corridor boundary will remove virtually all liability from the shoulders of the PBGC. This sponsor will be excused from premium payment.

THE PROBLEM OF TAX MANAGEMENT

Some observers will point to the potential our proposals offer for abusive tax management. Within limits, we propose giving the sponsoring taxpayer discretion over timing of taxable withdrawals. In many situations, current law already gives the taxpayer an element of discretion over timing of deductible contributions. This two-edged element of discretion does establish at least a theoretical potential for abuse.

But it should be remembered that this potential exists only so long as assets exceed the lower corridor boundary. Furthermore, any narrowing of the range of tax rates would reduce incentives for manipulation of this type. This narrowing is a key element of the President's Tax Reform Proposals. If operating losses could be carried forward indefinitely, and if there were just one corporate tax rate, these incentives would be virtually eliminated.

While we acknowledge that there is a theoretical potential for abuse, we question whether it is a practical problem. We propose working on the assumption that it is not. Should this assumption prove erroneous, restrictions could easily be added at a future date.

6. A POSSIBLE REFINEMENT

ADJUSTED ASSETS FOR PREMIUM PURPOSES

We have proposed applying a PBGC premium rate to the amount by which the upper corridor boundary exceeds 100% of assets. This means a sponsor's PBGC premium obligation will not reach zero until plan assets reach 150% of full termination solvency. Our rationale is that this 50% cushion will provide protection from market value fluctuation.

Assets come in different types. Within types, they come in different qualities. A simple 50% cushion ignores these differences. If agreement could be reached on objective distinctions, it would be useful to establish a cushion which is different for different types and qualities of assets. For example, the premium might be applied to the amount by which the upper corridor boundary exceeds adjusted assets. Adjustment might involve multiplying each asset item by a factor along these lines:

deferred annuity contracts	150% of present value (using the basis used to calculate termination solvency)
money market accounts and other cash equivalents	150% of market value
investment quality fixed income securities maturing within 3 years	145% of market value
longer term investment quality fixed income securities	120% of market value
investment quality equity securities	100% of market value
other investments	85% of fair value

We present this illustration only to show the format which might be possible. We do not suggest that the particular set of classifications used in our illustration is the most appropriate. Neither do we suggest that the percentages we have illustrated are the only possibilities.

We do believe that any classification used should be based on objective criteria. The plan sponsor should not be permitted to exercise discretion in determining the appropriate category for a particular investment.

7. ADDITIONAL STUDY

Assuming a consensus can be reached on the viability of our proposals, additional research is needed, to answer at least three questions.

First, what PBGC rate, applied in the manner we have suggested, would produce revenues roughly equal to those produced under the current per-participant arrangement?

Second, what objective criteria can be used, to determine whether an entity is in "imminent danger of bankruptcy?"

Third, suppose it is determined that assets should be adjusted along the lines of our more refined alternative. What objective rules can be established in determining, for example, whether a security is "investment quality?"

We look forward to a dialogue within the employee benefits community on these questions, as well as other aspects of our proposals.

We would welcome comments and questions respecting these proposals. Please direct all communications to:

American Society of Pension Actuaries
1413 K Street, N.W.
Washington, D.C. 20005
(202) 737-4360

October 1, 1985

Senator NICKLES. Thank you very much.

Mr. White.

Mr. WHITE. Mr. Chairman, due to your obvious grasp of the problems of the small businessman and in consideration of your time, I will just summarize my written comments.

I am speaking from the perspective of the president of a very small pension administration company, small by metropolitan standards. The employers that we generally represent are of 2 to 50 employees. We only administrate two plans that are larger than 50 participants.

We state, in short, please, no more changes in taxing fringe benefit retirement plans. For the past 2 years, my fees for amending our plans have exceeded the entire cost of administrating these plans—including recordkeeping, IRS and Department of Labor filings, and so forth.

Pension consultants and regulators of tax-qualified plans are still reeling from the effects of TEFRA, DEFRA, and the Retirement Equity Act, as you have heard. Even the national office of the IRS has admitted that it will be 2 years before they can consider all prototypes.

I have submitted field prototypes because I work almost exclusively in one IRS district. They wrote me back, in effect, to say "Thank you, we have the material. Don't even contact us within the next 90 days."

The committee, as legislators, must create an atmosphere for retirement savings, an incentive. I would disagree with one earlier testimony that 401(k) plans benefit primarily the fat cats.

I would say that they benefit almost exclusively the working people. The reason I say that, is in our particular operation of all the pension plans, and profit sharing plans we administrate, we do not administrate one 401(k) plan.

Primarily, we are working with small offices. It may be a two-man law office with a couple of secretaries, or an office in optometry: five or six people.

The recordkeeping is horrendous for that when you have voluntary contributions, mandatory contributions; they are investing in a couple of different assets; their contributions are generally monthly.

I sincerely believe that, in designing a retirement savings plan, the small employers can be better served through a standard profit-sharing plan. So the companies that are adopting these 401(k) plans are generally national companies.

In our town, I only know of one 401(k) plan and that happens to be the largest employer in our community. Now, our community is approximately 12,000 people, but that is the largest community in our county and the four counties that surround it.

I believe the working people are being served by the 401(k) because these national corporations are benefiting the most.

I will summarize by saying, No. 1, do not tax lower and middle-income Americans by putting new taxes on fringe benefits, including life and health insurance, group insurance.

Do not adopt the proposed pension changes which impose more tax—up to 50-percent taxation—on people who are disciplined enough to save for retirement: otherwise, Government will become their keepers after retirement.

And do not discourage small employers from adopting and maintaining tax-qualified retirement plans because of constant change.

Thank you for the opportunity to address you.

[The prepared statement of Mr. White follows:]

Address to the

UNITED STATES SENATE SUBCOMMITTEE ON LABOR

by

JIM WHITE of DURANT, OKLAHOMA

October 1, 1985

Mr. Chairman, members of the Committee, my name is Jim White and I am from Durant, Oklahoma. I am addressing you today as an individual and I thank you for this opportunity to address you concerning President Reagan's tax proposals.

I am President of a small, small by metropolitan standards, pension administration company. While I am addressing you as an individual, I feel I am representing my clients who generally are small business and professional persons employing two to fifty employees. I represent the entrepreneural spirit in rural America. In short, we say--

"PLEASE....NO MORE CHANGES ON TAXING FRINGE BENEFITS AND RETIREMENT SAVINGS!"

During the last two years, my fees for amending my client's retirement plans to comply with new laws, has been more than the total administrative cost including plan accounting, employee statements, and filing all Internal Revenue Service and Department of Labor filings. This is an added cost these small businessmen did not anticipate when they started their pension or profit sharing plan.

Pension consultants and the regulators of tax-qualified retirement plans cannot keep up with major changes being inacted by legislation every year. We are still realing from the changes necessatated by TEFRA (Tax Equity and Fiscal Responsibility Act), the DEFRA (Deficit Reduction Act) provisions of the Tax Reform Act of 1984, and the Retirement Equity Act.

For two years I have been unable to obtain a letter of determination of qualification from the IRS for my clients. The National Office of the IRS has been so swamped with retirement plan prototypes, they have already stated it will be up to two years before they can review them all for approval.

I thought it may be faster if I applied for a field prototype status, one that is only used in a specific (IRS) district. My last letter from them stated, and I quote, **"we cannot immediately review your plan. Therefore, to help us avoid further delays, please do not make any inquiries concerning the status of your application until at least 90 days."**

You, as legislators, must create an atmosphere of incentive for the American public to save and invest for retirement. Otherwise, the government will become their keepers after retirement. Constant changing of pension laws create an atmosphere of uncertainty and while multi-national corporations operating on investor's money can afford changes every year, the small risk-your-last-dime businessman cannot. I implore you to create a positive atmosphere for retirement savings.

While almost every American supports tax simplification because of a belief that the Internal Revenue Code of 1954, as amended, is antiquated and complex; always be aware that individuals and corporations adjust their policy to the tax environment. It is ludicrous to say **"we are going to close that tax loophole and raise revenue by X amount of dollars."** They all adjust their policy to the new tax rules. I am author of a FINANCIAL PLANNING HANDBOOK and I have one chapter devoted to every legal way (I could find) to take money out of a business tax-free.

Therefore, work with your colleagues and within other committees and make certain you:

- do not tax lower and middle income Americans by putting new taxes on fringe benefits, particularly health insurance;
- do not tax the inside buildup of cash values in life insurance, which goes against the doctrine of constructive receipt upon which our tax system is based;
- do not adopt the proposed pension changes which impose more tax, up to 50% taxation, on persons that are disciplined enough to save for retirement; and
- do not discourage small employers from adopting and maintaining tax-qualified retirement plans because of constant changes.

I am greatful for your having given me the opportunity to address the committee and would now like to answer any questions you might have.

Background Brief

of

JAMES A. (JIM) WHITE, CLU, ChFC

Jim White is speaking today as an individual and has traveled at his own expense to address the committee concerning President Reagan's tax proposals on fringe benefits and retirement savings. He has 15 years experience in the financial services industry, starting his career in the San Francisco Bay Area, but moving to rural Southeast Oklahoma 10 years ago where his practice serves primarily small business owners and professionals.

EDUCATION:

Graduate of the American College at Bryn Mawr, Pennsylvania and holder of the coveted (CLU) **Chartered Life Underwriter** and (ChFC) **Chartered Financial Consultant** professional designations.

BUSINESS AFFILIATIONS:

Owner of **JAMES WHITE FINANCIAL SERVICES**, a fee-only financial advisory firm.

President of **EMPLOYER PLANS COMPANY, INC.**, an independent pension consulting and administration company.

Jim White and Employer Plans Company, Inc. also hold insurance licenses with which many group insurance and executive compensation plans are written and funded.

EXPERIENCE:

Is Author of the FINANCIAL PLANNING HANDBOOK, a reference guide used by attorneys, accountants and financial planners in almost every state in the nation.

Has taught **Federal Income Tax Law** at the university level and his student's pass ratio is 20% above the national average on the national exam.

Has been licensed by the National Association of Securities Dealers and several states for over a decade.

Has consultated to banks and the home office of a life insurance company.

Senator NICKLES. Mr. White, thank you. I appreciate the comment.

We have heard the thrust of your comment from several of our witnesses: the burden, particularly, on small employers of constant changes. I think you mentioned TEFRA and DEFRA and the Retirement Equity Act, all in the last 2 years.

Let's say a small employer has a defined-benefit plan, a little pension plan, that says we'll pay you *x* percent of your salary when you retire at age 65. Then Congress comes in and makes these changes. If you have helped design this plan or helped a person set up the plan to keep it qualified, then you have to go back to the IRS and the Department of Labor, submit those changes and hopefully get those approved.

Is that the case?

Mr. WHITE. Yes, sir.

Senator NICKLES. How long does that usually take?

Mr. WHITE. Well, we have not received a letter of determination of qualification in 2 years because every time we submit one we might just as well withdraw it because a new law has been imposed.

We have had our last one submitted for a little over 3 months, I believe. So we have not received any determination there.

Senator NICKLES. Is that from IRS?

Mr. WHITE. From IRS, which of course is the approving agency for, basically, both agencies.

I have some plans that these employers are contributing $3,000 and $4,000 a year that could probably do as well or better in an IRA, except they don't want a total "gimme" for their employees—which, in my opinion in designing, is why I am not totally in favor of SEP's, because that is just a "gimme." You might as well just give the person a cash bonus and let them go do what they want with it.

The submission is a major process. One example, in the plan that we just submitted, that we drafted—and I knew it was going to be an unusually long prototype—on our word processor, which is normally 65 characters wide, we went 75 characters wide and it is single-space type; and it was 59 pages. Our adoption agreement is another 14. That is a heck of a legal instrument. I mean, that's enormous in complexity for an employer who has five employees.

Senator NICKLES. Then they have to come to you or somebody else and ask that you interpret that document?

Mr. WHITE. Oh, absolutely.

Senator NICKLES. Mr. Facciani, you mentioned a couple of comments that we haven't really dealt with on this concerning reversions. It is something that no one else has mentioned, but in which, as you know, I am interested.

That has somewhat tied up our progress in moving forward on a single-employer bill that deals with both the tax increase or premium increase—whatever you want to call it—for PBGC and also some reforms.

You mentioned that you had four or five suggestions that dealt with reversions. I remember you mentioning a possible committee.

We have been trying to come up with some alternatives that would be able to move us past center. In the administration's proposal, they provide for a 10-percent excise tax on excess funding or excess on that reversion, the 10-percent tax on it.

You stated that you are opposed to that?

Mr. FACCIANI. Yes.

Senator NICKLES. Is it your feeling that if we have a tax on reversions or a tax on excess-funded defined-benefit plans that, in effect, we will be encouraging in the future underfunded plans and we might end up seeing a greater dumping on PBGC?

Mr. FACCIANI. Absolutely, that's our feeling. We feel that the employers may change the way in which they are funding plans, change the actuarial cost methods of the plans so that there is no opportunity to accumulate much in the way of residual assets.

Senator NICKLES. Representing the American Society of Pension Actuaries, that might be another one of these costs that we are talking about because now, at the year's end, we have to have an actuarial statement on the health and status of these plans.

If I remember from looking at some past actuarial statements dealing with our plan we basically end up with a lot of terminology that's hard for the layman to resolve, but usually you end up with a couple of figures that he can understand.

One would be the minimum contribution amount and the other would be the maximum contribution amount that would be allowable for IRS purposes.

Do you think if there is a tax on reversions that employers, instead of maybe funding on the high side whenever their financial status would allow them to do so, would be much more inclined to always fund on the minimum side; fund on a minimum amount to get by in order to make sure that they wouldn't be looking at a possible tax on reversions in the future?

Mr. FACCIANI. Yes. If I were a businessman, which I am, if I had a defined-benefit plan, which we do not, and I knew that there as a possibility I would be paying a 10-percent excess tax on any reversion assets, even though I intended not to terminate my plan, I'd be loathe to put any more money than I needed to put into that plan.

Senator NICKLES. I appreciate your comment. I think it is one that needs to be heard, and I would also share that concern.

My main concern would be that business people would do exactly that. They would fund on the lower side and that would decrease the health and stability of defined-benefit plans. When and if some of those terminations do occur, planned or otherwise, you could see a greater liability coming forward on PBGC; and that means the surviving employer is going to have to pay that as well.

That's been my concern. I haven't really looked at your recommendations dealing with reversions. That is in your statement?

Mr. FACCIANI. No. It was just approved 2 days ago by our board so it wasn't in our statement.

I will be glad to provide you with a copy.

Senator NICKLES. If you would, I would appreciate it and we will make it a part of the record, as well.

Mr. FACCIANI. Fine. Thank you.

[Additional statements submitted for the record follow:]

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
BEFORE THE SUBCOMMITTEE ON LABOR,
U.S. SENATE COMMITTEE ON LABOR AND HUMAN RESOURCES
OCTOBER 15, 1985

The Investment Company Institute (the "Institute") submits the following statement on the Pension Policy Implications of the President's Tax Proposals on Retirement Savings. The Institute is the national association of the mutual fund industry. The Institute's membership includes 1,345 open-end investment companies ("mutual funds"), their investment advisers and principal underwriters. The Institute's mutual fund members have assets of approximately $408 billion, representing about 90% of total industry assets and have over 20 million shareholders.

Mutual funds have traditionally served as vehicles through which investors of modest means may channel their investment dollars into the nation's economy through a diversified, professionally-managed pool of investments. Mutual funds are increasingly providing the investment medium for retirement income programs. Three such programs which we will address in this statement include the Individual Retirement Account (IRA), section 401(k) plans and Simplified Employee Pension plans (SEPs).

INDIVIDUAL RETIREMENT ACCOUNTS (IRAs)

One retirement vehicle which has proved particularly successful is the Individual Retirement Account (IRA). Since its expansion in 1981, the IRA has not only served as an effective source of retirement income for the working people of the country, it has also provided an extremely important program for capital formation.

An Institute survey conducted this past year documents the significant contributions IRAs have made to retirement savings. According to the survey results, IRAs have enhanced the retirement programs of millions of households. At the end of 1981, when IRAs were made available to all working individuals under the Economic Recovery Tax Act (ERTA), the total pool of IRA assets consisted of $26 billion dollars with 4 million households owning IRAs. By December 1984, the pool had grown to $132 billion with 23 million households owning IRAs. Growth of this magnitude demonstrates that the public is not only aware of IRAs, but clearly recognizes that IRAs meet a basic need -- a need which we estimate will bring the total IRA pool, as of the end of April 1985, to almost $175 billion.

The 23 million households now owning IRAs reflect a broad spectrum of the American public. According to survey results, the majority of IRA owners have moderate incomes: about 15 million or nearly two-thirds of all IRA owners have incomes under $40,000. Of this group, as many as 7.5 million households owning IRAs have incomes between $15,000 and $30,000.

It is these moderate income households which are most dependent on IRAs because they frequently represent employees who do not participate or have very modest participations in employer-sponsored retirement programs. Therefore, in the absence of IRAs, these households could be largely dependent on Social Security payments upon reaching retirement. Interestingly, our survey indicated that it was concern over the future adequacy of the Social Security System which prompted many respondents, particularly those younger ones with incomes under $30,000, to open an IRA.

NEW SAVINGS GENERATED BY IRAs

IRAs have increased personal savings and have channeled a larger portion of such savings into long-term investments for capital formation. This positive impact of the IRA stems from two primary sources: (1) reinvested earnings generated by the expanding pool of assets just described, and (2) saving out of current income. For example, at the beginning of 1983, outstanding IRA assets totaled $52 billion. If we assume that these assets earned a nominal 8.0 percent, approximately $4.2 billion of new savings were generated during that year, all of which were automatically reinvested. In addition, we determined from our survey of the IRA market, that IRA owners -- through their 1983 contributions out of current income -- created $10 billion of new savings -- savings that would not otherwise have been made. In total, we estimate that IRAs added about $14 billion to new savings in 1983. The comparable number for 1984 is probably over $17.0 billion. It should be emphasized that no quantitative estimates of how savings generated by earnings on accumulated IRA assets can predict how future spending-saving decisions will be influenced. We believe, however, that saving in this form makes a significant net contribution to personal saving of the magnitude we have indicated.

The growth of the accumulated IRA pool has a multiplier effect. As total IRA assets grow, new savings from earnings on these assets will also increase. For example, the Institute has further calculated that the new addition to retirement savings from earnings on the IRA asset pool may be as much as $37.0 billion dollars in 1989. These figures are based upon a projection that IRA assets could reach $550 billion or more by the end of the decade. This estimate is large even though the assumptions underlying it are quite conservative. The following chart summarizes the retirement savings data:

NEW RETIREMENT SAVINGS GENERATED BY IRAS (Billions of Dollars)

YEAR	IRA ASSETS	NEW SAVINGS FROM CURRENT INCOME	NEW SAVINGS GENERATED FROM ASSETS*
1981	26	(no data)	---
1982	52	(no data)	2
1983	92	10	4
1984	132	11**	7**
1989 (ESTIMATE)	550+	13+**	37**

The Institute's survey has demonstrated that the IRA must, in the future, be recognized both for its importance in promoting economic security in retirement as well as its accelerating contribution to capital formation. To further enhance retirement savings and capital formation, the IRA contribution limits should be increased.

For this reason, the Institute endorses the proposal in the Administration's tax reform package which would increase the spousal IRA contribution limit from $2,250 to $4,000 each year. Unfortunately, this proposal to increase the spousal IRA limit has been dropped from the recommendations prepared by the staff of the Joint Committee on Taxation in conjunction with the

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* Assumes earnings on IRA assets at the end of the previous year will grow by an average of 8.0 percent.

** The figures for 1984 and 1989 assume patterns of savings behavior similar to that in 1983.

Ways and Means Committee mark-up of tax reform legislation. The Administration's proposal should be retained in any tax reform legislation. It would eliminate the existing discrimination against non-working spouses under current law and would permit both families with one wage-earner and those with two wage-earners to contribute as much as $4,000 each year to IRAs.

SIMPLICITY OF IRAS

The Institute believes that the IRA, as expanded in 1981 to provide universal coverage to all wage earners of every income bracket, is a unique, simple and effective savings and retirement vehicle. The IRA may be easily understood and established with a minimum of paperwork and red tape. It is a flexible program enabling IRA participants to exercise their freedom of investment choice through a variety of financial institutions which offer a broad selection of investment products. According to our estimates, the IRA market share breakdown at the end of May, 1985 is widely diversified:

INSTITUTION	PERCENTAGE
Commercial Banks	28.9
Mutual Savings Banks	6.0
Savings and Loan Associations	22.5
Life Insurance Companies	9.5
Credit Unions	7.5
Mutual Funds	14.0
Direct Investment in Stocks and Bonds	11.6

It is the freedom of investment choice, which sets the IRA apart from other retirement savings programs. In these other employer-provided retirement and savings programs, it is the employer who typically designates a single investment medium or institution or who permits his or her employees to select from a limited choice of investment media. Economic freedom is particularly important where, as with IRAs, enormous sums will accumulate over time.

The Administration Proposals

Unfortunately, certain Administration proposals have threatened to curtail the freedom of investment choice and the growth of private retirement plans and would inject enormous complexities into IRAs. One such proposal, which is buried in the Administration's tax reform package presented to the Congress last May, would require individuals covered by a section 401(k) plan, a so-called cash or deferred arrangement, to offset against their IRA contributions any elective contributions made by their employers to the 401(k) plan. This proposal, along with a proposal to cap elective 401(k) plan contributions at $5,000, have been included in the staff recommendations currently under consideration by the House Ways and Means Committee.

The proposed IRA-401(k) offset would provide that the amount of the 401(k) elective contribution made for the benefit of the employee would reduce dollar-for-dollar the amount the employee could contribute to an IRA. In effect, many wage earners would be forced to choose between contributing to an IRA or having a contribution made by their employer to their company's 401(k) plan.

This stealthy attack on the IRA savings program apparently has been justified as being part of a package to deal with issues involving 401(k) plans. But the proposed linkage between IRAs and 401(k) plans is not a rational response to the perceived 401(k) problem.

To the extent that there may be a concern that the non-discriminatory coverage standards imposed upon section 401(k) plans have not been fully effective, the Administration's proposals would substantially revise and tighten them. Similarly, to the extent that there may be a concern that 401(k) plans are used for short-term savings rather than retirement purposes, the Administration's package would restrict the use of loans and early distributions from 401(k) plans and other types of tax-favored retirement arrangements. Specific problems with 401(k) plans can and should be dealt with by specific cures.

IRA OFFSETS

The Institute opposes any type of offset provision, ~~as an~~ oblique attack against the IRA. Not only would such offsets have the ultimate effect of reducing IRA contributions, they would defeat that overall retirement savings purpose served by IRAs and section 401(k) plans.

In addition, the IRA-401(k) offset proposal strikes at the unfettered freedom of investment choice which is currently available to IRA participants. The offset proposal constitutes a type of governmental intervention which might permit employers to skew the investment choice to the more limited selections offered under an employer's 401(k) plan.

Moreover, the offset provisions will produce serious administrative complexities. What is now a relatively simple, easy to administer savings and retirement program would, of necessity, become burdened with a new set of rules and cross-reporting requirements necessary to determine the amount of permissible IRA and 401(k) contributions for a particular year. A currently simple, uncomplicated program would become burdened with a maze of paperwork and uncertainty -- ironically injecting complexity into a tax program which claims simplification as an important goal.

OFFSET COMPLEXITY

We believe any offset of this type extended to 401(k) programs would be unduly confusing to millions of employees who make contributions to IRAs and whose employers maintain 401(k) plans. In addition, the offset proposals could give rise to significant accounting complexities for the employee, the employer, the IRS and the retirement plan administrator.

For exampl , the offset proposal would seriously complicate the employee's tax return if the permissible IRA contribution were reduced by the elective 401(k) contribution. The employee's tax return on Form 1040 would have to reflect the offset, the employee would have to calculate the amount of the permissible IRA deduction and the IRS would have to check the result. An obscure instance in which an offset against the IRA contribution exists under present law occurs when the employer permits IRA deductible contributions to be made to the employer's plan as "voluntary deductible employee contributions." The complexities engendered by the offset have been so severe as to probably discourage the creation of these plans. First, the employee is unable to make the calculation on the Form 1040 or even the Form 1040 instruction book, but is directed by the Form 1040 instruction book to "use the worksheet in Publication 590," an IRS pamphlet that the employee must separately obtain. Second, the employee in such case is not permitted to use the simplified Form 1040EZ or Form 1040A. Because of these and other significant complications -- including a plethora of instructions -- most employers do not permit voluntary deductible employee contributions to be made to the employer plans.

Moreover, the additional instructions that would be required for all tax returns flagging the offset would confuse IRA contributors who would not know whether their employer's plan was a "401(k) plan" or some other type. Complications of this type fortunately were eliminated in 1981 when IRAs were made available to those eligible to participate in employer-sponsored retirement plans. The offset proposal with respect to 401(k) contributions would resurrect complexities that were eliminated by the 1981 amendment.

Another example of a potential administrative problem can be illustrated by a calendar year employer offering a calendar year 401(k) plan to a calendar year employee. The employer may have made salary reduction elective contributions on behalf of the employee to the 401(k) plan throughout the calendar year which presumably would have to be reported to the employee on a W-2 Form by January 31 of the following year. If the amount of such contributions totaled $2,000 or more, any IRA contribution made by the employee during the year would be considered an excess contribution which would have to be withdrawn.

However, there is the possibility that the employer may subsequently compute his earnings for the year by March 15 (or a later date if the time to file the employer's income tax return has been extended) and determine that he had no profits for the year. In this event, there would be no 401(k) contribution to offset against any IRA contributions. However, unless the employee receives a timely notification from his employer that the W-2 information was faulty, he may have already foregone the opportunity to make an IRA contribution for the year. The offset would produce even further complications for fiscal year employers and non-calendar plan years for 401(k) plans, because employees are generally on a calendar year basis.

Accordingly, we respectfully urge that the IRA contribution limits should remain independent of contributions made by employees to employer-sponsored retirement plans, whether or not the employer plans are 401(k) plans.

SIMPLIFIED EMPLOYEE PENSION PLANS (SEPs)

One final retirement program we want to address today is the Simplified Employee Pension Plan Program (SEPs).

In 1978, provisions for a Simplified Employee Pension (SEP) program were enacted in the Code (Section 219 and 408) to permit small employers to establish, in an inexpensive manner, non-discriminatory retirement plans for their employees by using IRAs set up for each employee. However, it has been the experience of the mutual fund industry that the SEP program has not been used extensively. Unfortunately the term "simplified" has turned out to be a misnomer. We believe that such simplification would have the highly desirable effect of encouraging small employers to provide employer-sponsored retirement programs for their employees on a non-discriminatory basis.

The Institute has developed several suggestions we believe should be adopted to simplify further the creation and operation of the SEP programs and substantially increase their use. We are currently reviewing these suggestions with Congressional, Treasury and IRS staffs. Among these suggestions are the following:

- The IRS has developed a simple form for use by employers establishing a SEP plan. However, the form cannot be used if the SEP plan is integrated with Social Security contributions or benefits. (even though the statute permits such integration in SEP plans.) If the plan is integrated, separate IRS approval of the plan is required at present. We believe that the simple IRS form could be made available to employers establishing non-discriminatory integrated SEP plans, and that its availability would greatly facilitate the adoption of the plans and reduce their cost.

- The present SEP system treats the employer contributions as compensation to the employee and allows an offsetting deduction to the employee on his income tax return. The employer contribution is not subject to income tax withholding or FICA or FUTA tax. Nevertheless, it must be reported as taxable compensation on the annual Form W-2 provided to the employee. The Form W-2 must also reflect the offsetting deduction to be taken by the employee on his income tax return. The adverse consequences of these requirements is that an employee, ordinarily eligible to use simplified income tax forms (1040EZ or 1040A), must now use the long Form 1040. None of these complications exists if employers maintain other types of non-discriminatory retirement plans for employees.

We urge that these and other unnecessary complexities can and should be eliminated in SEP plans in order to facilitate the use of the plans by smaller employers. We look forward to exploring these possibilities further with the Subcommittee members and their staffs.

National Coordinating Committee for Multiemployer Plans

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STATEMENT OF ROBERT A. GEORGINE, CHAIRMAN, NATIONAL COORDINATING COMMITTEE FOR MULTIEMPLOYER PLANS BEFORE THE SUBCOMMITTEE ON LABOR, COMMITTEE ON LABOR AND HUMAN RESOURCES, UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

It is a pleasure to discuss the vital subject matter of these hearings -- the impact of the President's tax proposals on employee benefits. I appear here today in my capacity as Chairman of the National Coordinating Committee for Multiemployer Plans ("the NCCMP"). The NCCMP was organized shortly after the enactment of ERISA, ten years ago, in order to represent the interests of the more than eight million men and women, and their families, who are covered by multiemployer employee benefit plans. The Coordinating Commitee's affiliates include more than 140 pension funds, health and welfare funds and related international unions.

I applaud you, Mr. Chairman, for keeping these issues at the forefront of the national debate on domestic priorities. Indeed, there is no subject which is of greater importance to America's workers today, especially in view of the apparent willingness among certain policymakers to consider legislation which would effectively cut back or outright eliminate these benefits that workers have earned for themselves and their families.

The NCCMP and its affiliates are deeply concerned about the continued viability of collectively bargained employee benefit plans. These plans provide a wide range of essential benefits to tens of millions of Americans who otherwise could not afford them. They provide financial security necessary for employees to live in dignity after retirement. They permit employees and their families to meet medical expenses during times of crisis and encourage preventive health care. They protect dependents against financial disaster in the event of an employee's premature death. They provide funds for basic necessities for unemployed and disabled workers and their families. They provide meaningful access to legal services for many lower- and middle-income Americans, who could not otherwise afford the legal assistance necessary to protect their rights.

America's system of encouraging the dedication of a part of each worker's wages to meeting certain critical human needs such as health care, education, life, disability and unemployment insurance and retirement security is fundamental to a stable, progressive society. We have made enormous progress during this century in fashioning a national policy of fostering these benefits through a combination of public and private programs. On the public side, the establishment of the Social Security system and its expansion from a retirement and disability income maintenance program to a program also encompassing the provision of basic health services for the elderly and poor is, of course, fundamental to this national employee benefits policy. But Social Security, Medicare and Medicaid only offer a benefit floor. It is the private system of employer financed employee benefits which has nurtured the well-being of the vast majority of American workers and their families.

Nonetheless, a disturbing trend appears to be developing to curtail the incentives that have played a key role in the development of such benefit plans. Most recently, the Deficit Reduction Act of 1984 imposed new limits on contribution deductibility and subjected the earnings of employee benefit funds to new taxes on so-called unrelated business taxable income. That Act also repealed the estate tax exclusion for benefits paid from pension plans. Before that, the TEFRA legislation subjected pension benefits to withholding taxes and imposed other restrictions and burdens on employee benefit plans. There have been several major efforts, so far unsuccessful, to impose a "cap" on health care deductions or, alternatively, to include a portion of an employer's payments for health care in the income of the beneficiary.

The likely consequence of hypothetical changes in benefit taxation may be specifically illustrated with respect to employer-paid health insurance. If the direct cost of such benefits were increased through additional tax burdens, the younger and healthier workers, who feel least likely to need such benefits, would likely drop out of plans where possible. This would be especially true of low-income workers who simply could not afford the additional cost. As their participation ended, the cost for the remaining workers would increase and eventually become prohibitive. The end result would likely be the destruction of many such plans.

This devastation could come about even more quickly in collectively bargained plans. In such plans, individual workers cannot opt out individually. The decision not to bargain over benefits is made by the collective bargaining representative for the group. Thus, the younger workers may likely vote to terminate health benefit programs.

As a result, older workers may lose the opportunity to obtain health care coverage through employer-paid programs. The cost of providing medical benefits increases dramatically with increased age of covered workers. For example, the cost of providing medical benefits to workers age 44 and under is only 80 percent of the average cost of providing benefits to all employees. This percentage increases with age to 112.5 percent for employees age 50 to 54, 125 percent for employees age 55 to 59, and 160 percent for employees age 60 to 64. Thus, many of these workers would be uninsurable on an individual basis or would find it impossible to obtain health insurance coverage at affordable rates. Through no choice of their own, they would be forced to rely on government programs. And just as important, the different goals and needs of older versus younger workers are likely to put additional strains on collective bargaining if the government forces workers to make these choices. Those strains would make it more difficult for collectively bargained plans to obtain the funding they need.

A similar pattern could result with respect to pension plan coverage. Younger workers may feel they have plenty of time before they have to worry about obtaining adequate retirement income. They may believe they can provide such income for themselves through IRAs or otherwise, once they get ahead and have money to invest. Thus, if the direct cost of their retirement benefits were increased through increased tax burdens, they would likely try to drop out of plans or ask their bargaining representatives to terminate such plans.

However, experience has shown that younger workers, especially lower-paid workers who have little discretionary funds, will not make adequate provision for their own retirement benefits through IRAs or otherwise. In addition, the financial security of current retirees, whose benefits may not be fully funded at the time of plan termination (and of the federal programs insuring these benefits), could be seriously jeopardized. This would be especially true in newer plans providing past service credit.

Any short-term deficit reduction brought about by curtailment of the existing benefit program structure would be far outweighed by the resulting, long-term demands for direct government expenditures. If essential retiree health and financial security were not available through the private sector, the demands for new and costly government programs could be overwhelming. Existing government programs are already facing a severe financial crisis, resulting in attempts to shift as much financial burden as possible to private sector programs. Clearly, it is important to encourage the continuation of the essential private sector contribution to the system.

Providing these benefits through tax subsidized private sector programs is far more cost-effective than providing them through government programs. Treasury estimates that the tax exemption for employer-paid health care benefits costs $18 billion in income tax revenues annually. However, the private sector health benefit program provides over $80 billion, or nearly five times the expenditure, in essential health protection. Without the private sector program, government programs, such as Medicare or Medicaid, could be called upon to spend that $80 billion directly. Moreover, in light of our experience with Medicare, Medicaid, and programs such as Great Britain's national health insurance, it is doubtful that the government could administer and fund equivalent protection for as little as $80 billion. Thus, tax subsidy of the private sector program is an extremely cost-effective method of providing these essential benefits.

On the cost side, particularly with respect to pension benefits, there is evidence that tax expenditures are nowhere near as high as the Department of Treasury estimates. Tax expenditure measures used in the budgetary process are calculated on a cash-flow or cross-sectional basis. Thus, the amount of taxes deferred by current pension plan participants is offset against the amount of taxes paid by current beneficiaries. This is an unrealistic measure which fails to distinguish between taxes deferred and taxes permanently lost to the Treasury. When tax benefits are measured in a lifetime context, with the amount of taxes deferred by particular participants offset against the amount of taxes that will eventually be paid by the same participants, the revenues lost to the Treasury decrease significantly. The real value of tax expenditures, measured in a lifetime context, is only about one-quarter the value of deferred taxes. Even after a present-value adjustment to reflect the interest foregone by the Treasury, the value of lifetime tax expenditures is less than half that of deferred taxes.

Even lifetime tax expenditure measures ignore the likelihood that higher-income taxpayers would invest in other tax-preferred assets (e.g., housing, state and local government bonds, or assets purchased for capital gain) in the absence of employer-paid pensions. Thus, a change in the current favorable tax treatment of pensions would probably not recover even the lower federal revenue expenditures estimated on a lifetime basis.

In short, the private sector retiree benefit program is a "good buy" in terms of tax expenditures. Its destruction, through curtailment of its favorable tax treatment, would create serious deprivation for older Americans and would likely impose substantial additional pressures on federally funded or assisted health and retirement programs. Any increased revenues resulting from taxation of such benefits would ultimately be outweighed by increased demands on government programs. Thus, taxing these benefits would increase, rather than decrease, federal budget deficits and the need to raise taxes.

While it is apparently more fashionable these days to focus attention on the various types of defined contribution plans, the facts are that defined benefit pension plans have remained popular and are growing. This is true both in terms of single- and multi-employer plans. And the reasons for this continued growth are clear. A defined contribution plan may help certain employees save a specific sum of money to be available for numerous contingencies, only one of which may be retirement. Even an IRA can be tapped by an employee prior to his retirement years. Thus, defined contribution plans are merely a form of savings. There are several other ways in which defined benefit pension plans are superior to defined contribution plans.

First, defined benefit plans provide strong incentives for a worker to remain with his or her employer or, in the case of multiemployer plans, to remain in the trade or craft covered by the plan. This makes for a stable and skilled workforce which contributes to our economy as a whole. Moreover, defined benefit plans encourage a more systematized approach to retirement in that there is a direct and positive correlation between the level and timing of pension benefits and the age at which workers retire. A regular monthly check payable at a definite time is a far more powerful retirement incentive than a one time receipt of a undeterminable lump sum.

Second, defined benefit plans can be adapted by employers to a wide variety of circumstances. Most important of these is the ability, through a defined benefit plan, for an employer or group of employers to provide meaningful levels of benefits for older employees by granting past service credit.

Third, as pooled investment vehicles, defined benefit plans can use their large assets in ways which are simply unavailable to managers of defined contribution plans. The structure of defined benefit plans allows a plan sponsor to know what it will need during any specific time period, thereby assuring greater flexibility in making investment decisions -- flexibility which allows for more creative uses of pension assets and higher returns over the long run. This, in turn, means the possibility of benefit increases and lower or more stable employer contribution obligations.

Finally, if for some reason investment returns or the ability to make contributions fall short of the need to pay promised pension benefits in a defined benefit plan, it is the plan sponsor -- not the individual plan participant -- who will bear the deficiency because the promised benefit must be paid. And, if the plan sponsor cannot meet its plan obligations, Title IV of ERISA guarantees the payment of benefits through the pension guaranty program which, in essence, puts the community of all defined benefit plan sponsors behind the promise of each individual plan.

Thus, the apparent preference for IRAs over employee benefits, particularly defined benefit plans, represents an additional example of the alarming trend to undervalue the enormous social importance of employee benefits when deciding matters of tax and pension policy.

Several factors appear responsible. First, the continuing federal deficits have created intense revenue pressures. Reducing the tax-favored status of employee benefits appeals to some as a low-visibility way to generate additional revenues. In our view, however, this nation cannot justify any attempt to balance the federal budget on the backs of the working men and women of this country. Our workers and their families depend on the retirement, health care, disability, life and unemployment insurance benefits provided by these plans. More equitable and humane ways of raising revenue exist than curtailing or eliminating these benefits.

Moreover, attempting to raise revenues in this manner is likely to be counterproductive. The curtailment of supplementary unemployment benefits, for example, would likely impose substantial additional pressures on federally funded or assisted welfare and unemployment programs. Cutbacks in the provision of pension benefits would create even more obvious participant needs. The loss of such benefits would also likely result in significant grass roots pressure for new programs involving direct federal spending. Existing federal tax incentives provide an efficient cost-effective incentive for the provision of these essential benefits by the private sector. Substantial curtailment of these incentives would represent short-sighted and ineffective economic planning.

A second reason for the restrictive legislative trend may be the instances of reported abuse -- for example, doctors and other professionals arranging for yachts to be contributed to a purported benefit plan. To the extent such abuses actually exist, the Coordinating Committee has no interest in protecting them. However, we believe that actual abuses must be carefully and precisely identified, and that any remedy must first be carefully tailored in order to excise only the abuse situation. Abuse surgery that cuts deeply into healthy tissue, for example the recent VEBA legislation, has already worked unnecessary and unfair hardship on participants in legitimate benefit plans. In this connection, we are aware of no abuse in collectively bargained plans, and no such abuse has been reported. It has long been established that the very nature of the collective bargaining process -- where the employer and the employee have a healthy adversity of economic interest -- precludes the kinds of abuses that may exist elsewhere. All other things being equal, an employer's economic interest does not lie in making excessive contributions to employee benefit plans. While contributions are in the employee's interest, employees generally want contributions limited to what is necessary to fund the benefit involved. A dollar in additional employer contribution generally means a dollar less in wages. Moreover, multiemployer plans are jointly trusteed, so that this healthy adversity is reflected in the administration of such plans. Finally, collectively bargained plans do not selectively provide benefits to owners or highly compensated individuals, thereby posing discrimination problems, as is generally recognized by the anti-discrimination provisions of the Internal Revenue Code.

Thus, in our view, the perception of abuse or abuse potential offers no justification for new restrictions of any kind on collectively bargained benefit plans. Apparent abuses in one sector should not be used as a smokescreen for revenue-motivated cuts in a nonabusive area. In this regard, we note that the House and Senate Labor Committees have a familiarity and expertise on collective bargaining issues that are not shared by all members of the tax-writing committees. We believe that your effective exclusion from the legislative consideration of these issues has produced many unfortunate results, and should not continue.

A third rationale sometimes advanced for restrictions -- for example the proposed "tax cap" on health care benefits -- is supposedly grounded in principles of efficiency and cost containment. Extend the incentive to a flat dollar amount, the theory goes, and actual health care costs will magically shrink to stay within the limits. Lower health care costs would benefit everyone (except perhaps the health care providers), and important social policy and federal revenue considerations would thereby be served.

This is, of course, pure pipe dream. The actual result would be the taxation of medical benefits for many middle- and low-income workers. Had the $175 per month "cap" proposed last year actually been adopted, one study conservatively estimates the following: 35 percent of the union-represented employees covered by multiemployer plans would have been subject to an average of $145 per year in additional tax. Some employees in the study would have owed nearly $500 in additional tax. In this respect, "cost containment" is nothing more than a pleasant euphemism for the imposition of taxes on health care benefits programs.

Moreover, the efficiency and cost-containment arguments have generally ignored the substantial, historical contributions of collectively bargained plans in these areas. Such plans pioneered experimentation with health care delivery systems designed to provide care efficiently and at low cost. These plans were among the first to utilize health maintenance organizations, second opinions on the necessity for surgery, and dental clinics. This experimentation has continued outside the health care arena, as our plans' experience with legal services programs amply demonstrates.

The Coordinating Committee believes that any reappraisal of the tax incentives presently afforded to employee benefit plans should not lose sight of the central facts. First, such plans -- particularly collectively bargained plans -- have proven to be overwhelmingly successful arrangements for the private sector provision of essential benefits. Many of those for whom such benefits are provided have totally inadequate personal resources, and would otherwise fall back on the public sector. Efforts to improve on a system that is working so efficiently may well prove counterproductive.

Second, any so-called "reform" measures must be carefully directed, so as to cover only instances of actual abuse. Such measures should not result in restrictions on plans, like collectively bargained plans, where the perceived abuse cannot exist or is otherwise already regulated by ERISA and related laws.

Finally, questions of revenue loss, efficiency and cost containment must be considered in the proper context. Historically, collectively bargained plans have been innovative leaders and experimenters in providing benefits efficiently and at low cost. Moreover, the "savings" from curtailment of tax incentives in this area may well be illusory, as plan participants will necessarily look to alternate sources -- primarily federal benefit programs.

Of course, the tax laws alone do not represent the only aspect of Federal law which impacts upon a national employee benefits policy. In 1974, the Congress enacted one of the most important pieces of public policy legislation ever to emanate from the legislative process. That legislation -- ERISA -- was a clear statement of national policy that we must continue to encourage and foster employee benefit plans while at the same time assuring that the assets and resultant benefits of these plans are fully protected for the current and future enjoyment of plan participants. Congress said at that time that it is only through the private sector that we are going to be able to assure meaningful levels of retirement, health, education and other welfare benefits. Congress said that these benefits are to be earned in the workplace and that the marketplace will determine how high or extensive these benefits will be. And Congress said that once employers and employees establish various types of benefit plans, those plans will have to meet certain basic minimum standards so that the promise to pay those hard earned benefits is not illusory. When all is said and done, Mr. Chairman, that is what our national employee benefits policy is today -- and it is as I have just described it. It is not a perfect policy and will continue to require the kind of fine tuning that took place in 1980 with MPPAA and in 1984 with REA. Moreover, as the NCCMP has been urging for years, we need a more rational regulatory approach by placing all jurisdiction over employee benefit plans in one agency dedicated to the preservation and flourishing of employee benefit funds. Let it not be said, however, that we have no national benefits policy, because we do, and it is a policy that should not be discarded or replaced in a casual manner.

Once again, Mr. Chairman, I applaud your current effort to evaluate the impact of the President's tax proposals on our national employee benefits policy. To the extent that the NCCMP can continue to be helpful in the process, we are ready, willing and, as always, available. If we are to succeed in this shared goal, we must look carefully at whether there is in fact anything wrong with the current system. If there really are significant problems with the present policy, those problems -- and their solutions -- must be targeted with precision. However, we must avoid unnecessary tinkering that would jeopardize the health of the employee benefit system. If we stay true to this course, we can continue to hope for a credible non-partisan approach to employee benefit plan regulation.

STATEMENT OF SMALL BUSINESS COUNCIL OF AMERICA, INC.

TO THE

SENATE COMMITTEE ON LABOR AND HUMAN RESOURCES'
SUBCOMMITTTEE ON LABOR OVERSIGHT HEARING

ON

PENSION POLICY IMPLICATIONS
OF PRESIDENT'S TAX PROPOSALS
ON FRINGE BENEFITS AND RETIREMENT SAVINGS

FOR THE RECORD

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SMALL BUSINESSMAN'S PLEA FOR PENSION SURVIVAL

Alvin Lurie, Esq.

"For both a sponsoring employer and an employee, setting up and maintaining a retirement program is and should be a long range project. This requires a high degree of predictability both in investment results and in the applicable tax and labor law rules.

Over the course of the last ten years, there have been many statutory and regulatory changes with respect to the tax law affecting retirement plans. This is unfortunate and has interfered seriously with long range planning. Probably more serious is the result that more and more small employers are opting out of the qualified plan area or are deciding not to set up plans because of the complexity and ever changing nature of the rules." Converse Murdoch,[1] Personal Correspondence May 16, 1985.

Introduction

Within a fortnight, the writer of these words was silenced by death, and Small Business lost its most ardent spokesman; but the words he wrote will not die, for they are the truth. They speak to the very essence of the problem. Only when that truth is finally heard in Congress will pension planning be free to resume its central role in our National Life, (i.e., to secure a decent retirement for working Americans). Surely, there are few goals, if any, more worthy of attainment. The sad reality, however, is that, for the past dozen years, private pensions have been sprayed as if they were some kind of a pestilence, to be controlled before they become too deeply embedded in the National body.

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[1] Mr. Murdoch was the first President of the Small Business Council of America. The quotation is from a letter he wrote to the Legislative Assistant to Congressman Russo, concerning H.R. 2424, introduced by Mr. Russo and others, to expand the minimum tax to include the yearly increase in value of nonforfeitable benefits under qualified pension and profit sharing plans. inter alia.

It was not always thus. For some thirty-five years following the Second World War, the private pension movement grew in this country to the point where, perhaps, one million plans covering some 20 million participants were in place, and these numbers were growing steadily. The basic statutory law changed only negligibly in this period, and was largely undisturbed by the flow of regulations and rulings. ERISA stopped all that. Its enactment, by a "slender Congressional consensus" (as the Department of Labor, Office of Pension and Welfare Benefit Programs, recently characterized it in a report on its Hearings on Investment Performance and Governance, in January 1985 (hereinafter the "Labor Department Report")), was responsive more to the debacle of one automobile company's plan than to any Congressional concern about the great bulk of plans. But the consequence has been that ERISA and its progeny, TEFRA, MEPPA, DEFRA and REA, have turned pension design and administration from broad straight runs into narrow, twisting slalom courses. Again, to quote from the Labor Department Report:

> "The legal and administrative structures of ERISA are intricate to the point of discouraging any but the indomitable. The language is confusing, full of special purpose acronyms (PBGC, SOL, OPWBP), legal shorthand (exclusive benefit rule, prudent man rule), and special numbering...." Id. at page 2.

It is not an exaggeration to suggest that private pensions may be the next candidate for the dinosaur club. They have grown very large in the third quarter of this century under conditions that were propitious to their development. But for the past decade, they have been forced to exist in an increasingly hostile environment, and it is not certain that they can last into the next century. ERISA, TEFRA, DEFRA and REA have been the four horsemen of the apocalypse for pension plans.

This legislation has been particularly disruptive to the plans of small companies. Indeed, the bias against small business plans has been only thinly veiled, at best, and often not veiled at all. The "top-heavy" rules, introduced into the 1982 legislation in the last stages of deliberations of the Congressional Conference Committee, without hearings or even advance public announcement, is a case in point.

The burdens of pension design and administration have literally gotten out of hand. They are only manageable at enormous cost and often only with the aid of computers, putting them beyond the reach of many small businesses, or, if not actually beyond reach, then certainly not cost effective.

Where once the preparation of a pension plan was an essentially straightforward legal task, well within the competence of general practitioners, it is today an excruciating chore beyond the capacities of even experts. The typical pension plan has grown from a document that might run from 20 to 30 pages into a tract of about 100 pages. Not only is the instrument now laden with welters of words, but it must be laced with scores of confusing numbers: contribution and benefit ceilings, deduction limits, combination factors, actuarial assumptions, top-heavy tests, pay-out period, vesting rates, etc. etc. etc.; and the penalty for failing to recite the right words or list the correct numbers is _only_ disqualification!

What has just been said in the preceding paragraph cannot possibly convey to one, who has not actually engaged in the drafting exercise, the pain, the burden, and the enormity of the effort that must go into writing a plan today. And that is only the beginning. The plan must then be administered, and that is even a more formidable task. If the employer provides its employees with two separate plans, an unbelievably difficult formula, which can vary from year to year in its application to different individuals, must be applied to every single participant each year, in order to be sure that the combination of benefits under the two plans at no time surpasses the fractions that the law prescribes for such cases. Participants' rights must be explained to them, and also their spouses' rights. Benefits must be calculated. Coverage must be monitored. Top-heavy status must be checked constantly; and, as a result, benefits and vesting may have to flip-flop from year to year. Survivor annuities must be implemented. Distribution rights must be explained to every single participant - lump-sums versus annual payments, single life or plural lives' annuities, roll-over versus plan-to-plan - and with a varied tax consequence for each alternative, be it tax deferral, ordinary income tax, 10-year averaging, capital gains tax, and even excise taxes.

This system, which is so essential to the retirement well-being of almost every American family, and, for that reason, critical to the solvency of the Social Security system, has been so over-regulated, in just the past 12 years, that it is frighteningly close to falling of its own weight. That statement is not meant as a cry of wolf. So complex, so casuistic are the system's workings, that they are known only to very few highly gifted experts. Obviously, a nationwide program meant for use by over one million employers for the benefit of about 40 million participants cannot be maintained by such a slight body of experts. What is, perhaps, even more troublesome is that the costs of repeated plan revisions and of administration are rising at an unacceptable rate, and benefit delivery has become so expensive for employers in the past decade that massive plan terminations are guaranteed, and untold numbers of new plans will never be established.

The defined benefit plan, particularly, is being abandoned in growing numbers, and retirement plans of all kinds are being dropped in favor of the much more meager, but self-operative, IRAs or employee-funded 401(k) plans. IRS approval letters for defined benefit plan terminations in 1984 were over 9,000, almost three-quarters of the number of new plan approvals. Contrariwise, profit sharing plan terminations totaled only 6,189, compared with three times as many new profit sharing plan approvals. Overall, IRS issued 30% fewer determination letters approving new plans in 1984 than in the preceding year.

In just the past few years, three major overhauls of the pension laws have necessitated three separate large-scale amendments of existing plans, with massive confusion, even among experts, as to when the different pieces of this process became effective, and when actual amendments have to be in place. The reaction of one employer was typical. After receiving his lawyer's summary of the requirements added by Congress just in 1984, the president of a small business in Georgia wrote to his lawyer: "Please do not update our plans for the 1984 REA changes, because we are going to close both plans. We will not make any more contributions. Should we wait until our year-end or do it now?"

Is the eventual extinction of private pension plans the object, or just an unintended consequence of the present policies? The President characterized, as the goal of his recent tax reform proposals, "an America bursting with opportunity". This is the age of the entrepreneur, he said. He heralded that "small but growing circle of heroes, the small business people, American entrepreneurs, the men and women of faith, intellect and daring who take great risks...." He proposed to motivate this group by lowered personal and corporate tax rates, and reduced capital gains taxes. We submit that a far more realistic motivator for the typical individual contemplating starting his own business is the opportunity to implement a substantial retirement fund for himself and his family. Few such individuals can look realistically to a sale of their businesses. They all can look, however, to building those businesses into sources of current income during their working lives and retirement years.

That is where the pension plan comes in. Not only will it bring forth the entreprenurial spirit to the greater glory of America, but it will also secure a solid retirement not only for the entrepreneurs, but also for all their employees. The object of our tax policy, then, should be to induce the adoption and maintenance of qualified retirement plans in greater numbers than ever. If one looks at the record of this past decade, however, one would have to conclude that the opposite was our National policy. We have had, since 1974, the enactment of a succession of oppressive pieces of legislation that have cracked down hard on private pension and related employee benefits, adding growing complexity, while diminishing benefits and escalating costs, and which threaten to put an end to private pensions. Sometimes it has been in the name of revenue enhancement, sometimes deficit reduction, and sometimes fairness or tax equity, as the President's newest tax reform proposals would describe it.

Still the process continues. The Administration's new proposals would add further severe restraints to the pension system to achieve "fairness" among taxpayers; and there is legislation now in the hopper that would go even further, in the name of women's equity. To justify the cut-back in pension benefits, by a supposed notion of tax fairness or tax equality for all, is specious, because, unlike the abusive transaction that have attracted Congress hostility and whose only _raison d'etre_ is to shelter income, pension plans are not tax avoidance schemes lacking redeeming features, but important instruments of National policy. They should not, therefore, be painted with the same brush as tax shelters.

The Senate Republican Leader, Mr. Dole, said in a talk to stock brokers reported in the public prints June 12, 1985:

> "Tax fairness is a great idea. It makes a great speech. But after making that speech, the deficit is still there."

He might also have added that fundamental needs of our Society, such as retirement, security, capital accumulation and entrepreneurial risk-taking, are also "still there". They carry costs in lost tax revenues that the Country has been prepared to bear since the earliest days of the Income Tax. They cannot be swept away in the name of tax fairness or rate reduction for the real cost will be even greater than the saving of a few percentage points in the capital gain tax or some ostensible lowering of the ordinary income tax brackets that the President's proposals might achieve.

For pension practitioners, the most common response to the newest proposals from the White House, in May 1985, was to race through the Official Explanation, with fear and trepidation, to learn what parts of the existing rules had been killed and what parts left as walking wounded. That, indeed, is what one has been obliged to do each time Congress or the Treasury produced a new revenue bill these past few years. Then the process has had to begin again to see how to put the pieces together, and how to explain to businessmen what had happened to the benefit plans they may have adopted or amended just before the change.

For reasons that are not easy to understand, the public at large - we in the business and pension communities, in particular - have accepted this flattening out of pensions with remarkable passivity. We can no longer justify our passivity. We believe it is long past the time when Small Business is entitled - yea, in the Country's interest, compelled - to open the window, raise its collective voice in a mighty roar, and yell, "we're sick and tired and we're not going to take it anymore." The pension specialists among us have been all too ready to regard themselves as not competent to deal with policy questions, and to confine themselves to mastering the intricacies of their subject.

Congress must stop making pensions the captive of every new legislative vogue. Pensions are not revenue eaters or budget busters. The taxes "lost" in pension plans are not lost, but, at most, deferred, and, in time, come back into the Revenues in far greater quantities. Pension plans are social benefits, enhancing the Nation's financial and economic well-being and impacting on it in varied ways. Pensions are essential back-ups to Social Security. They are also the largest catch-basins for accumulating capital in the Country. It has been estimated that "ERISA assets will comprise more than half of all debt and equity in the United States by the turn of the century", according to the Labor Department Report (at p. 4), involving more than one trillion dollars in liquid assets and heading towards three trillion (in constant dollars) over the next fifteen years. What is good for pensions is obviously good for the Country; for pensions are investing in America in far greater numbers than any other segment of the society.

It is not the burden of our argument in this paper that pension and other retirement plans have an immutable right to be developed without any external restraints. Obviously, at a time of increasing deficits, some cap on the extent of the current "expenditure" of federal revenues dedicated to sustaining a private pension system may be appropriate. Also, it is entirely proper to require that a scheme enjoying a substantial tax subsidy justify its entitlement by demonstrating how it advances the public interest. Hence, it is self-evidently the office of Government to regulate the system and to interpose mid course corrections as needed to protect the Revenues and to assure their fair distribution, as well as to redirect National goals from time to time.

However, when pension plan implementation, administration and maintenance are increasingly made more complex, more costly, more consumptive of management attention by rules manufactured in Washington, one would not have to be paranoid to conclude that the Government's actions might just possibly be motivated by an animus towards the private pension system. This suspicion is not easily disabused when established and reasonable business practices for compensating employees, which serve the legitimate interests of workers and at the same time support the National interest (e.g., in assuring a sound base for retirement, and in shoring up the imperilled Social Security trust funds, while also providing the Nation's largest capital investment pool) are forced to undergo repeated and disruptive reconstructions, absent the most urgent of provocations.

This, then, is our plea for a new beginning in pension policy: a more benign approach, a true simplification, an end to constant legislative upheaval. The members of this Association ask this not on behalf of ourselves alone. Indeed, it is not difficult to make the case that, the greater the complexity, the greater the job security of the experts that must be engaged to manage the complications. However, the pension specialists among the members of this Association (and there are many) believe there is a National interest that overrides any immediate considerations of self-interest.

It is time to redress the balance that has been struck by the regulators in Congress and in the administrative agencies, time to revert to a regulatory and legislative environment that warmly encourages the expansion of private pensions. As businessmen find ways to expand effective uses of private pensions, Congress and the pension regulators should not apply a force in the opposite direction. Newton's Second Law of Motion, that, for every action, there is a like reaction of equal force in the opposite direction, is good physics but bad pension policy.

It is not enough to halt this course. It must, in fact, be reversed. To reverse the trend will invite attacks from various sectors. The survival of the private pension system, as well as the stability of the capital investment markets, in which the pension funds are the dominant factor, may hang in the balance.

With the Position Paper that follows, the Small Business Council of America hopes to inspire all who wish for that survival to band together, Government servants and private citizens alike; for, as it was said long ago, we hang together or we will surely all hang separately.

POSITION PAPER OF
SMALL BUSINESS COUNCIL OF AMERICA, INC.

commenting on

THE REVISED TREATMENT OF RETIREMENT SAVINGS AS SET FORTH IN THE PRESIDENT'S TAX PROPOSALS TO THE CONGRESS FOR FAIRNESS, GROWTH, AND SIMPLICITY

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I. Background

The Small Business Council of America, Inc. ("SBCA") is a non-profit organization which represents the interests of over 2,000 small businesses located in 49 states. Most of these businesses maintain employee benefit plans qualified under I.R.C. §401(a). Consequently, SBCA represents the interests of a great number of businesses (and therefore employees) across the country who have a significant stake in legislation which affects the structure, implementation, and operation of qualified retirement plans.

According to statistics developed by the Office of Management and Budget, qualified retirement plans sponsored by small businesses cover more than six and one-half million employees. These plans are maintained by small businesses at significant expense. A plan document as well as other initial required the Internal Revenue Service and Department of Labor forms, notices and summaries must be prepared. Significant administrative costs must be incurred on an annual basis. The Internal Revenue Service requires a Form 5500 to be filed for each plan every year. Annual forms must be supplied to plan participants. Notices have to be handed out to each participant regarding IRA roll-overs and other tax ramifications at the time a participant is entitled to receive a distribution. Complicated elections and signed notarized consents must be received by plan administrators before pension funds in excess of $3,500.00 can be distributed to participants. In short, a small business must be willing to allocate substantial time and expense to the establishment and maintenance of a qualified retirement plan program. Commencing in 1982 with TEFRA, small plans have been buffeted by 3 Acts of Congress significantly revising plan law - TEFRA, DEFRA and REA. TEFRA must be listed high among the most unfair laws ever passed by the Congress. It singles out qualified retirement plans sponsored by small business for numerous burdens and costs - the very group least able to absorb these costs. These additional requirements, limitations and costs are contained in the so-called "top-heavy" rules.[2] The primary intent of TEFRA was to ensure minimum benefits for plan participants and to limit benefits for owner-employees. What was most disturbing about TEFRA is that the effect on the overwhelming majority of small plans was and is negligible. The overwhelming majority of small plans were already (i) providing benefits in excess of TEFRA imposed minimum benefits, (ii) had vesting schedules at least as fast as those mandated by TEFRA, and (iii) very few owner-participants of small businesses were receiving plan contributions in excess of the amounts resulting from the new TEFRA limitations.

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[2] A "top-heavy" retirement plan can only be a small to mid-size plan. By definition, a top-heavy plan is one in which the value of the plan interests allocated for certain owners and highly compensated individuals is in excess of 60% of the value of the interests allocated for all plan participants. It is obvious that mathematically, the larger the employee pool for any given entity the easier it is to be a non top-heavy plan. Conversely, the smaller the employee pool, the easier it is to be top-heavy. The top-heavy provisions are the only major non-elective provisions of the Internal Revenue Code which discriminate between small and large entities. The "penalties" for being deemed a top-heavy plan include the following required provisions: (i) mandated vesting schedules for benefits, (ii) additional minimum benefits that must be provided to common-law employees, and (iii) a limitation on the maximum amount of compensation that may be considered for plan contribution purposes.

Two sad facts emerged from the legislative process connected with TEFRA. First, no public hearings were held prior to the law's passage. Rather than this major legislation being the product of a careful study of the private pension system, it arose out of the hopefully well-meaning, but by no means documented, cries of abuse by a few members of Treasury and a Congressional desire to reduce the deficit by cutting back on pension benfits. The alleged abuses, to the best of SBCA's knowledge, have never been documented, and whatever abuses might have existed can and should be controlled by IRS and DOL through existing audit procedures. It appears short-sighted to pass legislation which inhibits pension growth in the private sector in order to reduce the deficit in the immediate future, especially since there has been no comprehensive analysis of the impact of these provisions.

Second, assuming arguendo, that the top-heavy legislation was desirable for small plans, then it should have been equally desirable for large plans. When this issue was posed to one of the leading tax staff advisors in the Senate, his response was "You're absolutely right, but there's no way we could get this by big business." The reason for this digression to TEFRA is that in many instances the President's Proposal indirectly (and sometimes directly) impacts or affects small plans far more than mid-size to large plans. The top-heavy rules appear to be the only required rules in the Internal Revenue Code that single out small businesses and their scope is essentially expanded in the President's Proposal. Small business, though apparently appreciated by Senators and Congressmen during election periods, unfortunately appears to be the poor cousin at all other times. Sadly, at the very time the President is proposing the fourth major pension law since 1982 which will again require substantial amendments to existing plans, the Employee Benefit Research Institute (EBRI) has found as the result of a nationwide survey (sponsored by EBRI and the U.S. Department of Health and Human Services) that small companies with fewer than 100 employees are less likely to provide qualified retirement plans than larger companies. EBRI also found that between 1979 and 1983, the coverage rate fell from 61% to 56% among nonfarm workers. The study concludes that if small companies could be encouraged (presumably through tax incentives) to sponsor retirement plans at the same level as companies with 100 to 500 workers, then approximately 7.6 million additional employees would be covered by qualified retirement plans. It is imperative that Congress recognize and understand that such growth will never take place absent a lessening of the restrictions on small plans. In fact, the opposite will occur until the law becomes stable for a relatively long period of time and small plans are treated the same way as other plans instead of being singled out unfairly.

If Congress deems it prudent for small plans to continue, then no further pension legislation should be undertaken for many years without very careful thought and study. Small business simply cannot continue to assimilate the increased costs and burdens that recent pension legislation and this proposed legislation would impose on them. Make no mistake about the President's Proposals with respect to qualified retirement plans being minor or "fine-tuning" legislation. In particular, the deduction rules contained in Chapter 14.03, the revised cash or deferred arrangement (I.R.C. §401(k)) rules contained in Chapter 14.06, and the non-discriminatory coverage test contained in Chapter 14.09 are major departures from existing plan law. Small businesses, if they choose to retain their qualified retirement programs would be required to somehow learn and be able to properly administer another substantial change in plan law and significantly amend their plans yet one more time.

The President's Tax Proposals, which have been presented under the banner of "fairness, growth and simplicity," are none of these to the sponsors of a small business retirement plan. The legislation is unfair because it singles out small plans for harsher treatment than other businesses. It certainly will not sponsor growth in the small plan area. (In fact, SBCA contends that this legislation will probably be the final straw and that significant numbers of small plans will be terminated.) These proposals do not simplify the qualified retirement plan area for small business at all. This proposed law is one more in the TEFRA, DEFRA and REA line that is unduly complicated. Many proposals that appear benign on their face become administrative nightmares when translated into the real world of pension plans. Unfortunately, it appears that the individuals drafting these laws and proposals have little or no practical experience with pension plans and thus do not understand the problems the private pension system is now encountering. Perhaps the best example of how these proposals neither "promote" fairness nor simplication with respect to small business plans, is found in Chapter 14.04 dealing with the overall annual limits on contributions and benefits (the so-called 1.25 rule):

> Reasons for Change
>
> ... Calculation of the overall limit imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area. It requires an employer to maintain significant records for many employees and to coordinate the contributions and benefits under all of its tax-favored plans....
>
> The overall limit on the annual contributions and benefits that may be provided to an individual under a defined contribution plan and a defined benefit plan of an employer would be eliminated. For top-heavy plans, however, the existing overall limits would continue to apply. (Emphasis added, see Chapter 14.04)

Here the President has clearly recognized the unnecessary complexity and burdens of the 1.25 rule but has decided that only large and some mid-size plans should be exempted from this complexity. Small plans sponsored by small businesses are arbitrarily and unfairly singled out to continue to calculate this overall limit which the President's Proposal itself calls "the primary source of complexity in the retirement plan area" and one which "imposes a significant burden on employers and plans."

II. Increased Spousal IRA Limits - Chapter 14.01

Chapter 14.01 of the President's Proposal suggests increasing the present maximum IRA contribution for a nonworking spouse from $250 per year to $2,000. The SBCA commends the President for this provision.

It is hoped that this proposal would promote individual savings, which is a worthy goal particularly in light of general concerns about the long term prospects for the Social Security system. Presumably, the proposed increase in the spousal IRA will encourage couples to make IRA contributions for nonworking spouses so that these non-earning spouses will have something to fall back on for their own retirement years.

To promote the practical and social goals of IRA's, the SBCA suggests that certain designated events, in addition to death and disability, should be deemed sufficient to allow a pre-59-1/2 distribution without penalty, such as a medical emergency. It is probable that more couples will take advantage of the increased spousal IRA if they know they can reach the funds in the event of a dire emergency.

The SBCA contends, however, that the increase in the permissible contribution level for a spousal IRA cannot and does not in any way justify a cutback to any other part of the private pension system. It is imperative to keep in mind that the increased spousal IRA will probably not be taken advantage of by many families with one working spouse since many such families simply do not have enough disposable income for an increased IRA contribution. Further, retirement security for the nation will primarily have to rest upon qualified retirement plans sponsored by governmental entities and private companies.

III. Unification of Plan Distribution Rules - Chapter 14.02

The SBCA generally approves of the President's goal of treating distributions from retirement plans in a more consistent manner. No one knows better than a small business owner just how difficult and expensive it can be to attempt a deciphering of the numerous complex distribution options and procedures. The expense of hiring an administrator or an attorney to prepare the distribution package involving options concerning annuities, lump sum payments, rollovers, consent requirements and timing of payments is often significant for a small business.

SBCA notes that the President's Proposal (as under current law) provides that distributions must commence by April 1 following the year in which an individual attains the age of 70-1/2, except for IRA's and for individuals who do not own more than 5% of the entity sponsoring the plan, in which case a participant can choose to defer the receipt of his/her first distribution until April 1 of the calendar year following the year in which he/she retires, if later. The SBCA disapproves of the unfair singling out of the small business owner who must begin receiving distributions as of the April 1st following the year in which he or she attains age 70-1/2 even though he or she has not retired. If the President is concerned about restricting tax-favored plans to situations in which individuals will only receive benefits for retirement purposes, then what possible justification can there be to require an individual who owns more than 5% of an entity to receive benefits before actual retirement?

SBCA understands the President's concern that ten-year forward income averaging and capital gains treatment may not serve useful purposes because of (i) the reduced effect of progressive tax rates in light of a permitted rollover to an IRA and (ii) the implicit suggestion that the receipt of a large distribution may not provide for a retiree's long-term protection. However, both these considerations ignore the needs of many retirees. In many situations the payment of a retiree's benefits through an annuity or payout over a specified number of years may be the appropriate coverage to ensure that such individual is protected throughout his/her retirement years. A lump sum payout at retirement, however, may very well serve the needs of other retired employees; for instance, a retiree may wish to purchase a retirement home with the retirement funds or to pay off existing indebtedness. Are these inappropriate motives which should result in such individual paying tax at the highest tax bracket levels? Ten-year forward averaging prevents the substantial depletion of an individual's retirement fund upon distribution. SBCA recommends the retention of ten-year forward averaging in order to enable a retired (disabled or terminated) employee to have a realistic alternative in determining how he or she should handle the distribution of his or her plan benefits. A retired person should have the option to draw his or her retirement money in whatever manner he or she chooses, whether in periodic installments or in a lump sum.

The SBCA agrees with the President's proposal that failure to satisfy the highly technical minimum distribution rules should not subject the plan to disqualification. The issuance of uniform rules to provide guidelines, with additional taxes and penalties if the guidelines are not followed, appears more appropriate than the penalty of disqualification.

SBCA also approves of the President's attempt to standardize the early distribution rules. The safe harbor of a life annuity or a term certain of at least 180 months which commences at or after age 50 in order to avoid the imposition of an excise tax is a welcome addition to the pre-59-1/2 distribution rules.

While the SBCA recognizes the 20% and 10% excise taxes suggested by the Proposal are an attempt to recover some of the tax advantages obtained by the participant upon distribution, the President does not seem to appreciate the necessity of an early distribution in the event of a family or business emergency such as a medical emergency (not tantamount to disability of the participant) or death of a participant's family member prior to the time a participant reaches age 59-1/2. Exceptions for certain emergency situations, which would permit early distributions without any penalty, in addition to disability or death, should be incorporated. College expenses and those distributions connected with the purchase of a first principal residence can be anticipated, whereas medical emergencies cannot. The 20% excise tax appears to be more analogous to a penalty tax than a recapture tax inasmuch as the 20% rate is higher than some of the marginal brackets under the President's proposals. In addition, it must be remembered that neither the employer nor the employee had the use of these funds while they were in the plan.

The Proposal acknowledges that the deferral of tax on the distribution of unrealized appreciation in employer securities encourages investment in such securities. However, the proposal states that because these may be for nonretirement purposes, the deferral option should be revoked. The SBCA opposes this measure. The tax system must be read in a broader light. The deferral not only rewards the employee's investment in employer securities but also benefits small business by improving employee morale, encouraging greater productivity and by promoting capital investment.

SBCA suggests that the distribution rules provide clearer and more specific guidance upon their issuance. Some of the distribution rules, such as the spousal consent rules, the IRA rollover treatment, and an explanation of the income tax treatment of lump sum distributions, require forms which must carefully adhere to legislative requirements. The adoption of any new distribution provisions should not be introduced without requiring the government to produce forms and explicit directions that can be used by small business in this extremely complex area.

III. Modification of Deduction Rules - Chapter 14.03

The President has proposed that the existing 15% profit sharing plan deduction limit based on the aggregate compensation of all participants should be abolished and that a new individual limit of 15% per participant should be introduced. The President's rationale for this change is not convincing. The individual I.R.C. §415 limits in this area are sufficient. If all of the President's Proposals were adopted, then the following maze of limitations would be placed on retirement plans:

(a) Existing individual Section 415 limits -

(i) the contributions and other additions on behalf of an individual under a defined contribution plan for a year may not exceed the lesser of $30,000 (indexing beginning in 1988) or 25% of the individual's compensation for the year in question;

(ii) the contribution to a defined benefit plan to fund an individual's annual retirement benefit may not exceed the contribution necessary, under reasonable actuarial methods, to fund an annual retirement benefit of $90,000.00.

(b) Proposed individual 15% of compensation limit on deductions for contributions made to a profit sharing plan;

(c) Proposed 25% of aggregate compensation limit on deductions for total contributions made to a combination of defined benefit and defined contribution plans;

(d) Existing overall limit (1.25 rule) for each individual who is covered by both a defined contribution plan and a defined benefit plan. This old limit would continue to apply only to top-heavy plans (i.e., PLANS SPONSORED BY SMALL BUSINESS).

(e) Proposed phase-in of the $90,000.00 individual I.R.C. §415 limit for defined benefit plan over a ten year period.

(f) Proposed 10% recapture tax on the amount of annual benefits received by a participant from all retirement plans that exceed 1.25 times the defined benefit dollar limit in effect for that year.

Any system that requires this many limitations cannot survive for long. SBCA strongly suggests that the I.R.C. §415 limits be retained, the existing I.R.C. §404 deduction limits be retained, the overall 1.25 limitations be repealed for all plans and that no further contribution or benefit limitations be placed on qualified retirement plans. These limitations alone provide sufficient guidelines to prevent an abusive system.

The proposed modifications set forth in Chapters 14.03 and 14.04 certainly run counter to the old adage "If it ain't broke, don't fix it". There is no evidence that the existing limitations on contributions and benefits are not working. In fact, with respect to the 1.25 limit the Proposal recognizes that the situation is already one of overkill and the 1.25 limit "imposes a significant burden on employers and plans, and indeed may be the primary source of complexity in the retirement plan area." One would hope that the Congress and the President will recognize that the introduction of two new limitations and significant changes in two others will do nothing to simplify this already overly complicated area.

Perhaps one of the more discouraging portions of this Proposal is the reference to a new "retirement type" of profit sharing plan. This "retirement type" of profit sharing plan would be allowed to have a carry-forward of unused limits to succeeding years. This complicated exception would be applied on a participant by participant basis and could only be applied if five conditions were satisfied. These conditions are: (1) the individual is an active participant under the plan; (2) the individual is not a participant in any other qualified profit-sharing or stock bonus plan maintained by the employer; (3) contributions on behalf of the individual are based on a contribution or allocation formula using a reasonable year-of-service factor; (4) employer-derived benefits attributable to the year and to any other year for which the plan was a "retirement-type" plan are not available, either by distribution or loan, before separation from service, death, or disability; and (5) the plan is not top-heavy. Once again, the clear bias against retirement plans sponsored by small business is evident since a small plan can never qualify as a "retirement type" of profit sharing plan. This is simply inequitable and unjust to the six and one-half million workers and owners who are covered by small plans. There is no justification for this type of discrimination.

The Proposal advocates modifying the existing 25% aggregate compensation limit on deductions for total contributions to combinations of pension plans and profit sharing or stock bonus plans so that it would be applied to combinations of defined contribution plans and defined benefit plans. For example, if an employer maintains a money-purchase pension plan and a defined benefit pension plan, the employer's deduction for total contributions to both plans would be limited to the greater of (1) 25 percent of the aggregate compensation paid to the employees covered by the plans, or (2) the amount necessary to satisfy the minimum funding standard for the defined benefit plan.

SBCA questions the rationale advanced by the President in support of this modification. The proposal appears to take an inconsistent position with respect to the nature of a profit sharing plan in the context of extending the 25% rule to money-purchase pension plans. The Proposal states that a money-purchase pension plan is akin to a profit sharing plan when only two paragraphs before the Proposal highlights the major differences between a profit sharing plan and a money-purchase pension plan.

In any event, the practical effect of this provision will be the cutback of pension benefits for employees throughout the country and numerous terminations of money-purchase pension plans. Few employers maintaining defined benefit plans and money-purchase pension plans would choose to keep the money-purchase pension plan where the overall contribution limits for the combined plans would be equal to what could be contributed to the defined benefit plan standing by itself!

The Proposal sets forth an annual tax of 10% on excess contributions for the year of contribution and for as long as the excess contribution remains in the plan and is not deductible. It is not clear how this rule is to mesh with the existing mistake-in-fact doctrine. Before any meaningful remarks could be made on this proposal, clarification of this provision would have to be forthcoming.

V. Modification of Annual Limitations on Contributions and Benefits - Chapter 14.04

These modifications are perhaps some of the most far-reaching changes in the President's proposals with respect to qualified retirement plans. By and large, they add another deep layer of complexity to the pension area.

This Statement has already alluded to the unfairness of the

President's Proposal to abolish the overall 1.25 limit for all plans other than small plans (i.e., top-heavy plans). The President's analysis is as follows:

> Eliminating the overall limit for non-top-heavy plans would eliminate a significant source of complexity and thus would promote the adoption of tax-favored plans. It should also provide employers with a significant incentive to maintain both defined contribution plans and defined benefit plans.

Obviously, the President does not think it is important that plans sponsored by small and mid-size businesses be relieved of concededly unnecessary complexity, nor does he think small business should be given an incentive to sponsor both defined benefit and defined contribution plans for their employees. The rationale for this distinction cannot be discerned by SBCA.

The proposal which would apply an additional 10% tax on all benefits distributed to or with respect to a participant from all plans, including IRA's and tax sheltered annuities, which exceed 1.25 times the defined benefit dollar limit in effect for the year, should be the subject of careful study before it is incorporated into the pension system. Numerous questions immediately surface with respect to the operation of this provision: 1) The analysis section of this Proposal states that implementation of this section will not require significant employer involvement. One must presume then that it is primarily the responsibility of the employee. Whether this is a prudent allocation of responsibility is not clear to SBCA but hopefully this is at least a grudging acknowledgement that employers simply cannot handle any more responsibilites in the retirement plan area.

(2) It is not clear why the President has determined that the individual I.R.C. §415 limits are not satisfactory in this regard. It is very possible that employees who at all times were within the IRS limits allowable with respect to contributions or benefit accruals will be hit with this additional tax. The analysis indicates that an employee may be forced to take a distribution in excess of 125% of the defined benefit amount in any given year due to the minimum distribution rules. Certainty of the law is an essential element to a well run pension system, let alone tax system. Here, it is easy to hypothesize a plan participant who at the eleventh hour will be hit with an additional 10% tax with no warning or way to avoid the tax when the participant was at all times within the limits of the law.

Finally, the proposal sets forth a phase-in of the $90,000.00 annual benefit I.R.C. §415 limit over the first ten years of plan participation. The rationale advanced for this additional complex requirement is that by forcing a defined benefit plan to be in existence for ten years in order to attain a $90,000.00 normal retirement benefit, typically "small employers" will not delay the establishment of this type of plan and thereby foreclose coverage of the plan for employees who worked for the employer in earlier years. Most practitioners who have helped establish defined benefit plans for small businesses do so only after the business has shown that it is steady and profitable enough to maintain a defined benefit plan. Generally, the first plan of a small business is a profit sharing plan. If and when a business continues to prosper, a money-purchase pension plan may be added. A defined benefit plan is only added once stability has been achieved. The suggestion in the President's Proposal that many small businesses do not provide their earlier employees with as good a retirement plan as later employees ignores the financial realities of a small business. This new limitation would again add one more layer of complexity to this already arcane system.

VI. Ten Percent Recapture Tax To Qualified Plan Assets Reverting to the Employer - Chapter 14.05

The President and the Treasury have proposed that an excise tax of 10% should be imposed on all plan funds reverting to the employer upon plan termination. The rationale advanced is that the Federal government is entitled to recapture some portion of the tax advantages provided with respect to such funds. While the SBCA explicitly recognizes that this Proposal is far more workable than the proposals set forth by Senator Roybal, the SBCA is not convinced of the equities of such a tax. Any person skilled in the pension area knows that a defined benefit plan is at any given time either underfunded or overfunded. It is all but impossible to be exactly funded at any given time due to the many variables involved. Given a choice between defined benefit plans being underfunded or overfunded from a national viewpoint, it is clear that plans should tend toward overfunding. The claims experience of the Pension Benefit Guaranty Corporation in the last several years bears testimony to the problems of underfunding. Basically, then, Congress must of necessity determine whether a 10% tax on excess assets reverting to the employer will cause employers to demand that actuaries under fund plans. This is a highly charged area due in large part to the recent terminations of several very large plans with large plan reversions. These excess plan assets are largely the result of recent high yields in equity and income investments. This issue would not have arisen during the recent recession. It is important therefore to assess this proposal based on long range security for employees rather than on the basis of two or three spectacular plan reversions. SBCA believes that perhaps the tax advantages provided with respect to excess funds may very well be offset by the loss of the use of the funds over the years by the employer so as to provide retirement benefits for its employees. These retirement benefits are necessary for our country's well being since it seems clear that the Social Security system will not be able to provide significant retirement benefits for the post World War II baby boom generation.

VII. Revision of Cash or Deferred Arrangement (Section 401(k)) and Employer Matching Contributions Rules - Chapter 14.06

While SBCA recognizes the President's attempt to expand coverage of the I.R.C. §401(k) Plans to more employees and to limit percentage differentials between the highly compensated employees and other employees, SBCA is strongly opposed to the proposal on Section 401(k) plans. These proposals take an already complex area and make it substantially more complex. The President's Proposal explicitly recognizes the worth of CODA's:

> Some greater liberality in the limitations on CODA contributions is appropriate because of the effectiveness of CODAs in encouraging employees to save for retirement. The most important CODA feature is flexibility: employees need not make elective contributions unless their own financial circumstances permit. A higher annual limit on elective contributions facilitates this flexibility by enabling employees to catch up in a subsequent year for not having made elective contributions in an earlier year. Many employers make employer matching contributions with respect to elective contributions, thereby further enhancing employee participation. The availability of plan loans, distributions upon hardship or separation from service, and numerous investment options also add to the relative attractiveness of CODAs. Finally, some claim that employers that would not otherwise adopt tax-favored plans are adopting CODAs.

The underlying assumption of the Proposal is that companies will continue to operate 401(k) plans under harsher rules which will necessitate plan amendment and far greater plan administration. These plans already require a great deal more administration than other qualified retirement plans - it is by no means clear how much more of an administrative burden, if any, employers will accept to maintain these plans or to establish new ones. Under the President's Proposal, the employer would be required to establish the amount of the employee's IRA contribution and adjust the 401(k) contribution accordingly.

Specifically, SBCA is against limiting the I.R.C. §401(k) election to $8,000.00 reduced by IRA contributions. The 401(k) contribution should only be limited by the individual I.R.C. §415 limitation. The more employees can save for their own retirement, the better off the country will be in the long run. Further, as a mechanical matter, the IRA contribution is generally made in April after the time the 401(k) contribution would already have been made. Therefore, if anything, an IRA contribution would have to be reduced by the 401(k) contribution and not vice versa.

The existing one-third to two-thirds mathematical test is much easier to deal with than the proposed prohibited group member test which will require employers to keep extensive records for a three year period. If the President believes that the one-third to two-thirds test is not producing the correct split, perhaps a one-fourth to three-fourths test could be adopted. It is important, however, for the sake of simplification that this test be a simple mathematical test which can be based on current census data.

SBCA believes that different adjusted deferral percentages (ADP) will further complicate the area and once again introduce an element of uncertainty into pension law. Moreover, there does not seem to be any good reason advanced why the more highly compensated employees cannot comprise one group for ADP purposes.

SBCA believes that taxing excess contributions at a 10% rate will cause employers to incur additional administrative expenses so as to avoid this tax. SBCA suggests that excess elective contributions, along with the attributable plan earnings, should be distributed by the end of the plan year to which the contributions related. Such a required distribution should not be treated as violating the distribution restrictions applicable to elective contributions or to qualified plans generally. Also, the distribution should be exempt from the early distribution recapture tax applicable to tax-favored plans. The major advantages of elective contributions to a 401(k) plan are to permit employees to determine (i) their desired level of retirement contributions, (ii) the investment vehicle and (iii) the tailoring of retirement savings to meet individual retirement goals. There does not appear to be any rationale for first imposing a 10% tax on excess contributions and then forcing a distribution, when excess contributions are almost always the result of an administrative error in calculating the ADP percentages.

The nondiscriminatory eligibility test will be discussed in the next section in some detail. SBCA strongly opposes this test and the even harsher test set forth in the 401(k) plan area. The

Administration appears to be unaware of the increased use and dependence of 401(k) plans by a wide range of employees at all levels and especially those in a small plan context. A recent study by Towers, Perrin, Forster & Crosby has discovered that almost two-thirds of all employees who are eligible to participate in a 401(k) plan actually do participate. Contrary to what the President's Proposal would suggest, the study generally found that the smaller the number of employees in a plan, the greater the level of participation. Thus, 401(k) plans in a small business generally involve a greater percentage of lower paid employees than plans sponsored by large corporations.

SBCA is against requiring coverage of employees after a one year wait. A 401(k) plan is a profit sharing or stock bonus plan. The same eligibility requirements that apply to these plans technically, by definition, should apply to 401(k) plans.

The proposed elimination of hardship distributions under a 401(k) plan is ill-conceived. Many employees will simply not put money into this type of plan if they know they cannot get to it in the event of a medical or other financial emergency. It is probable that many companies will prohibit loans from their 401(k) plans if the President's Proposal on loans is promulgated into law, due to the complexity of the Proposal. If loans and hardship withdrawals are eliminated, SBCA believes that participation in 401(k) plans by employees will drop off precipitously.

SBCA also suggests that the employer matching contribution area is unduly complicated and that existing law serves very well.

If the President's Proposals on 401(k) plans are promulgated into law, then an entire new body of pension law and regulations will have to arise in the 401(k) area. It is disturbing that neither the Treasury nor the Administration seems to either be concerned or aware that many thousands of companies have established 401(k) plans for employees in the last three or four years in reliance upon the law remaining constant. It is also apparently not understood that 401(k) plans entail significantly more administrative expense on the employer's part then other retirement plans. A great deal of communication with employees is required. An administrator must make sure that payroll deductions are proper and that notice of designated election periods are given to employees. For most employers, this feature (payroll deductions) takes nearly one year to put into a workable framework from the employer's and employee's perspective. This whole structure will have to be revamped at significant cost to employers. It is simply not fair to these companies or their employees to have the law completely rewritten.

The tremendous amount of planning that has gone in to working out the procedural and substantive aspects of 401(k) plans was delayed by rather weak guidance from the IRS. If, as in the past, regulations are not promulgated for two to four years after the passage of this new law (much less the technical corrections which will necessarily be mandated), once again pension law will be set back several years when the validity of this new system is still unproven. It is essential that Congress recognize that certainty in the law is the keystone of retirement planning.

VIII. Modification of Benefit Forfeiture Rules - 14.07

SBCA approves the President's Proposal to permit forfeitures under a money purchase pension plan (resulting from a participant who terminates service and is not 100% vested at the time of such termination) to be allocated to the remaining participants in the plan. This would be an additional option in lieu of present law which restricts such forfeitures to either reducing administration expenses or future plan contributions.

IX. Modification of Loan Rules - 14.08

Existing law permits loans to be made to a plan participant or beneficiary without the loan being treated as a taxable distribution provided certain conditions with respect to the terms and amount of the loan are met. The modifications proposed by the Administration have as stated purposes: (i) restricting employees from maintaining a permanent loan balance (often the $50,000 maximum) by reducing the frequency by which large loans can be made and (ii) narrowing the exception to the five-year maximum payback rule to include only first-time purchases of a principal residence by and for an employee. The SBCA feels these modifications are unduly complex and would be extremely difficult to administer.

I.R.C. §4975 prohibits plan loans made to an owner of a business or a member of his/her family through the imposition of a prohibited transaction tax unless certain stringent conditions are met. These conditions include restricting loans so that they (i) are available on a nondiscriminatory basis, (ii) are made in accordance with the provisions of the plan, (iii) bear a reasonable rate of interest, and (iv) are adequately secured. TEFRA contained additional restrictions with respect to the maximum amount that can be borrowed and the term of the loan. The Tax Reform Act of 1984 added further protective measures to ensure that plan loans were not being abused.

The SBCA opposes the introduction of these new proposals for several reasons. First, the administrative burden and complexity of these new rules are simply too great. Not only would the plan document have to be amended but somehow the plan administrator would have to explain these provisions to the company's employees. It is hard to imagine that a small plan sponsor could understand these provisions when most pension plan experts cannot. This type of provision generates the common perception by small businesses that they are simply overburdened by rules, regulations and administrative expenses in the retirement plan area.

VIII. Modification of Nondiscriminatory Coverage Test - Chapter 14.09

SBCA strongly opposes the proposed 125% non-discrimination test on the grounds that it is (i) extraordinarily complicated; (ii) requires maintenance of employee records for an on-going three year period to determine prohibited group members, (iii) the private pension system, particularly the small plan system, cannot tolerate the weight of this type of legislation. SBCA respectfully submits that if the purpose of all these provisions is (i) to remove the nondiscriminatory coverage test or as it is commonly referred to as the reasonable cross-section test and (ii) to reduce the three year wait to a two year wait, then do so and be done with it. The 70/80 test is a more than satisfactory test and has withstood the test of time. It is clear to any person who is in day to day contact with the operation and administration of retirement plans that the retirement plan system is perilously close to collapsing from the onslaught of recent legislation and regulation. It is the opinion of SBCA that this proposal will serve only to hasten the demise of the system and will certainly not add to the coverage of new employees.

There is also an obvious question as to how this law would apply in the context of a one participant plan. Mathematically, the test does not work in the context of a plan covering only one prohibited group member. This is obviously an oversight and must be corrected.

SUMMARY

After struggling to cope with TEFRA, DEFRA and REA, the small business community cannot help but feel their retirement plans exist in an openly hostile environment. SBCA believes that many small businesses which have maintained their plans in spite of all the administrative and economic obstacles would consider another revamping and "improvement" of the present pension system as the final step in forcing them to terminate their plans. The effect of these terminations will not only hurt the small business owners but the 6-1/2 million participants covered by small plans. As noted earlier, even the Labor Department in its analysis of the grandfather of modern day pension law, ERISA, acknowledged that "[t]he legal and administrative structures of ERISA are intricate to the point of discouraging any but the indomitable." The progeny of ERISA have made ERISA look simple. ERISA was and is a well conceived and ably drafted body of legislation, but the same cannot be said of TEFRA, DEFRA, REA or the President's Proposals.

The SBCA has long been a proponent of a three-pronged system by which the (i) government, (ii) the employer and (iii) the employee-participant all share in the responsibility of financing an employee's retirement. With the Proposal's disincentives for contributions by both the employer and the employee, an increased portion of the burden will fall on the government. Obviously, the Social Security system cannot accept any greater portion of this responsibility. The Proposal's inclusion of expanded spousal IRAs will probably not be very helpful, since a majority of households already have two wage earners. A significant number of couples with a single working spouse will be financially unable to take advantage of the proposed increased contribution limits.

Further, Congress and the Administration appear to have confused pension plans with "tax shelters." However, unlike an abusive tax shelter which shelters income without any other real purpose or goal, pensions serve several important national policies. The private pension system provides for the retirement needs of employees, serves to spur the economy as well as provide investment dollars, and serves as a supplement to the Social Security system.

The private pension system functions in large part because of tax incentives. Small businesses, however, cannot continue to maintain their plans if they must absorb more and more administrative costs due to constantly shifting pension laws, particularly in light of the blatant unfair singling out of small business retirement plans.

The sad but unquestionable answer to the President's Proposal is that the small business community can no longer afford to incur the costs of constant amendments to their plans and plan procedures. The bottom line and unfortunate result is that many small business companies will simply terminate their plans rather than bear the burden of assimilating one more complex and far-reaching pension law.

LEGISLATIVE INFORMATION

STATEMENT OF

THE NATIONAL EDUCATION ASSOCIATION

ON

TAXATION OF EMPLOYEE BENEFITS

BEFORE THE

SUBCOMMITTEE ON LABOR

COMMITTEE ON LABOR AND HUMAN RESOURCES

UNITED STATES SENATE

OCTOBER 15, 1985

MARY HATWOOD FUTRELL, President • KEITH GEIGER, Vice President • ROXANNE E. BRADSHAW, Secretary-Treasurer
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STATEMENT OF
THE NATIONAL EDUCATION ASSOCIATION
ON
TAXATION OF EMPLOYEE BENEFITS

Mr. Chairman and Members of the Committee:

The National Education Association, representing 1.7 million education personnel in the nation's schools and institutions of higher education, appreciates this opportunity to present its views on current tax reform plans as they affect employee benefit provisions for education personnel.

First, NEA agrees that tax reform is urgently needed. In our view, current law is unnecessarily complex and the burden of taxation is not fairly distributed in terms of ability to pay. Our perspectives on this issue reflect a membership that is representative of middle class America. The median age of NEA members is 39. Seventy-two percent are women, and about 73 percent of the total membership is married. Average salaries from school employment range from $17,998 in the Southeast to $23,128 in the West. Total average income, including that of a spouse, is $36,061. Nineteen percent of NEA members live in cities, 30 percent live in suburbs, and 51 percent live in small towns or rural areas.

For tax reform to succeed and be widely acceptable, NEA believes that current proposals to modify the tax code should be measured against the following criteria.

1. Tax reform must promote equity, fairness, and balance.
2. Tax reform must assure adequate revenues to finance education and other critical public services.
3. Tax reform must be in accord with national priorities, especially the drive for excellence in education.
4. Tax reform must result in a structure that is both workable and acceptable.

The Principal Issues Affecting NEA Members

On balance, NEA believes that the Reagan Administration's current tax plan is a significant improvement over present law in many areas. We strongly support the proposal to make permanent the exclusion of employer-paid educational assistance and group legal services from taxable income. We applaud the increase in the flat-rate deduction for individuals and families (zero bracket amount) and personal exemptions, which are long overdue and would be of great benefit to the 65 percent of American taxpayers who do not itemize deductions. The expanded earned-income tax credit would help take families in poverty off the tax rolls. A strengthened minimum tax on the wealthy and on prospering corporations would enhance public confidence in the fairness of the federal income tax system.

But in many other respects, the Administration plan falls short of tax equity. It dampens progressivity. Indeed, some of its provisions are more regressive than current law. Since 1981 we have seen a drop in the top marginal rate from 70 to 50 percent, and a further drop to 35 percent is proposed. The top capital gains rate has been reduced from 40 to 20 percent, and a further drop to 17.5 percent is proposed. These lower rates are a boon to millionaires, but not to the average taxpayer. The Administration's own documents show that taxpayers earning more than $200,000 a year would receive a much larger tax reduction in dollar amounts than middle-income taxpayers. And while the Administration makes much of the fact that taxes for lower-income taxpayers would be reduced by as much as 35 percent, this reduction amounts to only $30 for a family of four with an income of $10,000. For the $200,000 income family the tax reduction would be $9,500. These, again, are the Administration's own numbers.

The proposed changes in depreciation rates and the preferential rates on capital gains are touted as economic stimulants. However, we call the Committee's attention to "The Failure of Corporate Tax Incentives," a Citizens for Tax Justice study of the effects of the business investment incentives in the 1981 Economic Recovery Tax Act. The study showed that between 1981 and 1983 the 50 lowest-taxed corporations actually reduced their investment in new plant and equipment. The justifications for tax breaks for business, as consistently proposed by this Administration, are wearing thin. Increasing the purchasing power of individuals is a much more powerful stimulus to the economy, and a truly progressive system does just that.

EFFECT ON EDUCATION PERSONNEL

Imposing a Tax on Health Insurance Premiums

NEA strongly supports the Administration proposal to make permanent the Congressionally mandated exclusion of employer-paid educational assistance and group legal services, and deplores the Ways and Means proposal to repeal this section.

Just as strongly, we oppose the Administration's attempt to impose a tax on the first $10 worth of employer-paid health insurance premiums for individuals, and on the first $25 worth for families, and a proposal before the House Ways and Means Committee to impose a tax on health insurance premiums over a certain monthly limit ($120 for single taxpayers, $300 for married couples.

The Administration plan is is one of the most regressive proposals in the whole package; it adds $120 to $300 of nondisposable income for every wage earner to be taxed regardless of income level. It would effectively restrain future efforts to improve health benefit packages because employees would likely shy away from benefits that are subject to taxation. Future negotiations between management and labor would be clouded by the probability that improved benefits would be taxable -- to a limited degree now, but in all likelihood to a greater extent down the road.

The Ways and Means proposal looks less damaging, but it also sets a precedent that could easily lead to the taxation of more and more of employee benefits -- particularly if the objectives of tax reform in this Congress are limited by the principle of revenue neutrality. When taxes must be raised in the future, as we are sure they will be, the taxation of employer-paid health benefits would be established and the cap set today could be reduced tomorrow. In this way, the regressivity of the Administration plan would be introduced, and in a climate that would invite further mischief.

Even more disturbing is the prospect that taxing a portion of employee benefits would, over time, open the door to taxing all employer-paid benefits. In our view, the longstanding policy of excluding employee benefits has advanced the health, education, and welfare of the American family just as much as the array of direct government-funded assistance to individuals and families. For middle-class Americans this provision has had a broad and deep effect. More than 95 percent of NEA members are covered by health insurance - at least partially paid by their employers.

The exclusion of health benefits has opened up access to health care through the development of a vast system of employee group insurance, available regardless of age, sex, physical condition, or nature of employment. The contributions of employers and employees have significantly reduced pressures on charities and on social and governmental services. A tax on health premiums would not advance public policy. It would do nothing to reduce the costs of health care. It would not enhance private coverage of individuals to decrease public costs.

The Treasury claims that this provision would be easily administered, but goes on at some length to describe how the premium costs would be determined, adjusted periodically, and estimated under single and multiemployer plans. The additional employer record-keeping and compliance with nondiscrimination rules would add yet another layer of paperwork to an already considerable burden.

Public education personnel receive low salaries, as vividly shown in the appendix to this statement. Employer-paid benefits are important to these workers. Opening the bidding on taxation of benefits would be a further financial pressure against staying in the profession. Pension coverage and health benefits are two of the benefits that to some degree balance the small paycheck. For many teachers and support staff, the taxation of these benefits would be the "last straw" forcing them to leave education.

A significant longterm effect of taxing employee benefits would be the need to enact additional money measures to compensate for the relative dollar loss of employer-paid benefits. NEA believes the nation cannot now or in the future afford the loss of those benefits. The tax law has encouraged pension coverage broadly among lower- and middle-income workers, affording families a type of savings plan that would be difficult to maintain on individual initiative. Educational assistance has helped the unemployed, the underemployed, and lower wage earners to help themselves. Group life and accident insurance provide enormously valuable protection to families, and such programs are for most workers an irreplaceable supplement to private insurance and Social Security coverage. Tax law which provides these significant benefits to society must be preserved.

Other Key Benefit Issues

The Administration's proposals regarding employee retirement savings plans must be viewed in the context of employee benefit packages, and there are three areas of principal concern to the NEA.

1. Tax Deferred Annuities

Under current law, I.R.S. Code Sec. 403(b), employees of public schools and certain nonprofit public service organizations are allowed to defer paying taxes on a portion of their income. This law, in effect since the late 1950's, is an enormous incentive for talented people to work for schools rather than in the private sector. It enables public schools and other nonprofit organizations to more closely compete with the private sector's higher salaries and better benefits. It has been segregated from other tax-deferred plans such as IRA's, 401(k), and Keogh plans in that it allows for access to funds without penalty prior to age 59½. The Administration proposal would change the dollar amount that school employees could defer from income to a maximum of 16 2/3 percent. Also, the proposal would eliminate partial withdrawals prior to age 59½ without imposing a severe 20 percent tax penalty.

Most people working in education do not earn enough to change to more aggressive vehicles, and therefore see their tax-deferred annuities as their primary financial planning tool and often their only means for buying a home or sending children to college, as well as supplementing their inadequate public retirement plans. Also, the inability of education personnel to make a withdrawal without severe penalties or to borrow against their funds would prevent them from accessing the only funds they may have set aside for the future. The Administration proposal unfairly changes the rules in the middle of the game for such employees, and it would exclude public employees from participation in 403(b) plans. NEA strongly urges that Congress retain the current 403(b) provisions intact.

2. Employer Matching Contribution Rules

Current law allows employees to elect to defer the receipt of cash compensation and have the deferred amount paid as an elective contribution to a qualified profit-sharing or stock bonus plan. The Administration proposal would not permit tax-exempt organizations and state or local governments to enter into such arrangements on the grounds that such entities already have pension plans and tax-sheltered annuities. The 401(k) cash or deferred arrangement (CODA) plans allow a great deal of flexibility -- employees need not make elective contributions unless their personal financial circumstances permit. Employees may invest up to 20 percent of salary in these plans, employers may contribute an additional 15 percent, and employees may borrow against their savings. The CODA has greater rollover flexibility for both the employee and the employee's widow or widower. Lump sum distribution can be averaged over ten years, as opposed to only four years under other plans. These features are not available in other annuity plans available to our members, and we urge that they continue to be available to public employees.

3. Educational Travel Deduction Benefits Instruction

For many years, teachers have used educational travel as an effective way to upgrade their teaching skills. Their personal experiences in a variety of political, cultural, and literary centers of the world have contributed substantially to the improvement of instruction in the classroom. The Administration seeks to disallow deductions for educational travel purely on the grounds that present limitations fail to distinguish adequately between costs incurred for business purposes and costs reflecting personal consumption.

Current law permits the deduction of travel expenses only if the major portion of the activities during the period of travel is of a nature that directly maintains or improves skills required in the taxpayer's employment or business, and case law differentiates clearly between deductible and nondeductible expenses. We think this is fair. The President's proposal would simply deny deduction of education travel expenses because it is inconvenient for IRS to identify abuses. Events during the tax season of 1985 suggest that, if the convenience of IRS is a criterion for decisionmaking about the tax code, the whole system of taxation should be scrapped!

More clarity in the regulations would be preferable to an outright cancellation of the deduction, which would make it impossible for many, if not most, teachers to further their education and training in this way. We urge that this proposal be rejected.

CONCLUSION

The National Education Association supports tax reform and believes that the tax code should be progressive and support the independence of the family. It should strike a fair balance between individual and family taxpayers as well as corporate taxpayers. For acceptability to the public, the tax code should be based upon a fair and progressive distribution scheme which does not unduly burden the poor or the middle class. Finally, the tax code should be simple for taxpayers and cost-effective to administer. On many of these criteria the Reagan plan succeeds. In other critical areas it fails; we have identified them within our testimony. For the well-being of public education and the men and women who work in America's schools we ask that you give particular attention to assuring that the state and local tax deduction continues and that employer-provided benefits remain untaxed.

Average Salaries of Instructional Staff, 1984-85
Showing Percent Increases over 1983-84
and Purchasing Power in 1967 Dollars

	State	Average Salary of Instructional Staff	Percent of Increase Over 1983-84	Purchasing Power in 1967 Dollars
1.	Alabama	20,834	14.3	6,282
2.	Alaska	41,000	5.1	12,357
3.	Arizona	25,838	8.0	7,268
4.	Arkansas	19,575	11.8	5,885
5.	California	27,580	5.9	8,175
6.	Colorado	25,382	5.1	7,602
7.	Connecticut	25,650	8.4	7,622
8.	Delaware	24,134	11.3	7,243
9.	District	29,770	3.5	8,897
10	Florida	22,480	8.0	6,546
11.	Georgia	21,407	10.0	6,371
12.	Hawaii	25,295	1.1	7,656
13.	Idaho	20,420	9.5	6,124
14.	Illinois	26,703	6.8	8,029
15.	Indiana	23,882	7.2	7,177
16.	Iowa	21,686	3.9	6,507
17.	Kansas	22,564	9.5	6,592
18.	Kentucky	21,300	2.2	6,248
19.	Louisiana	20,110	7.0	6,121
20.	Maine	18,935	5.8	5,698
21.	Maryland	26,782	7.3	8,039
22.	Massachusetts	28,000	5.0	7,495
23.	Michigan	29,610	5.0	8,828
24.	Minnesota	26,500	6.4	8,057
25.	Mississippi	16,519	1.0	4,965
26.	Missouri	21,362	5.9	6,357
27.	Montana	22,440	4.9	6,747
28.	Nebraska	21,529	7.3	6,265
29.	Nevada	23,550	.7	7,000
30.	New Hampshire	19,276	6.9	5,775
31.	New Jersey	26,310	8.0	7,810
32.	New Mexico	23,240	7.3	6,859
33.	New York	29,700	6.2	9,015
34.	North Carolina	21,357	13.0	6,432
35.	North Dakota	20,480	3.3	6,186
36.	Ohio	23,682	6.8	7,068
37.	Oklahoma	19,520	1.9	5,884
38.	Oregon	25,974	7.5	7,737
39.	Pennsylvania	25,113	7.6	7,596
40.	Rhode Island	25,253	8.1	8,512
41.	South Carolina	20,770	13.9	6,155
42.	South Dakota	18,048	5.3	5,395
43.	Tennessee	20,450	12.1	6,242
44.	Texas	23,500	12.0	7,025
45.	Utah	24,475	6.5	6,623
46.	Vermont	19,640	8.0	5,910
47.	Virginia	22,400	9.5	6,694
48.	Washington	26,727	5.1	7,961
49.	West Virginia	20,451	11.9	6,081
50.	Wisconsin	25,160	8.6	7,703
51.	Wyoming	26,935	6.0	8,302

Source: Estimates of School Statistics, 1984-85
NEA Research

Table 18.--Summary of Selected Fringe Benefits for Teachers in Reporting School Systems by Per Pupil Expenditure Level of School System, 1983-84

	Per Pupil Expenditure					
	$3,500 or More	$3,000 to $3,499	$2,500 to $2,999	$2,000 to $2,499	Less Than $2,000	Total-All Reporting Systems
Number Responding	193	165	314	279	100	1,051
Percent Providing Vacation Leave	4.7	2.4	5.4	8.2	12.0	6.2
Percent Providing Sick Leave	99.0	99.4	99.4	99.3	97.0	99.0
Specified No. Days per Year1/	98.4	98.2	99.4	99.6	97.9	98.9
Provided as Needed1/	1.6	1.8	1.0	.7	3.1	1.3
Sick Leave Counts Toward Retirement Service	21.5	26.2	34.9	37.5	26.8	31.0
Percent Providing Personal/Emergency Leave	95.9	97.6	96.2	96.1	98.0	96.5
Charged in Whole or Part to Sick Leave1/	23.2	26.1	44.0	42.5	33.7	36.0
Percent Providing Sabbatical Leave	71.5	75.8	68.5	57.3	45.0	65.0
Mean Number of Leave Days						
Vacation Leave--						
Days Credited per Year	12	24	11	13	14	13
Maximum Accumulation	17	22	26	26	26	25
Sick Leave--						
Days Credited per Year	13	12	12	11	11	12
Maximum Accumulation	161	148	139	127	99	136
Personal/Emergency Leave-- Days Allowed per Year	4	3	3	4	4	4
Percent Providing Insurance Group Hospitalization	97.9	98.2	97.5	95.7	91.0	96.6
Single Coverage1/	93.7	90.7	85.0	88.0	86.8	88.5
Fully Paid1/	92.6	88.9	81.0	80.3	78.0	84.1
Family Coverage1/	92.6	88.9	82.0	82.0	80.2	84.9
Fully Paid1/	48.7	46.9	31.4	26.2	16.5	34.4
Medical/Surgical	96.9	97.6	95.2	93.2	89.0	94.8
Single Coverage1/	92.5	91.3	84.9	88.8	84.3	88.4
Fully Paid1/	91.4	89.4	80.9	81.5	75.3	83.9
Family Coverage1/	91.4	89.4	81.9	82.3	78.7	84.7
Fully Paid1/	46.5	46.6	31.8	26.5	16.9	34.2
Major Medical	98.4	97.6	96.5	94.3	90.0	95.8
Single Coverage1/	92.1	91.9	85.5	87.5	83.3	88.1
Fully Paid1/	91.1	90.1	81.2	80.6	73.3	83.6
Family Coverage1/	91.1	90.1	82.5	81.0	77.8	84.5
Fully Paid1/	47.4	47.8	30.7	25.3	17.8	34.2

See footnotes at end of table

Table 18 --Summary of Selected Fringe Benefits for Teachers in Reporting School Systems by Per Pupil Expenditure Level of School System, 1983-84 (Continued)

	Per Pupil Expenditure					
	$3,500 or More	$3,000 to $3,499	$2,500 to $2,999	$2,000 to $2,499	Less Than $2,000	Total-All Reporting Systems
Percent Providing Insurance						
Dental	83.4	73.3	73.6	53.0	28.0	65.6
Single Coverage1/	87.6	94.2	84.0	89.9	82.1	87.8
Fully Paid1/	86.3	90.9	81.0	87.2	75.0	85.1
Family Coverage1/	80.1	84.3	73.2	81.8	75.0	78.7
Fully Paid1/	43.5	48.8	33.3	43.2	17.9	39.9
Vision Care	35.2	28.5	28.0	21.5	5.0	25.5
Single Coverage1/	92.6	91.5	77.3	93.3	100.0	87.7
Fully Paid1/	91.2	87.2	73.9	90.0	100.0	84.7
Family Coverage1/	80.9	78.7	58.0	76.7	60.0	71.6
Fully Paid1/	45.6	46.9	35.2	53.3	20.0	44.0
Prescription Drugs	66.3	63.6	54.5	58.8	43.0	58.1
Single Coverage1/	93.0	90.5	83.0	90.2	79.1	88.1
Fully Paid1/	92.2	90.5	81.3	82.3	69.8	84.6
Family Coverage1/	88.3	89.5	78.4	82.9	69.8	83.0
Fully Paid1/	43.0	49.5	30.4	29.9	14.0	35.0
Mean Percent of Insurance Premium Paid If Less than Full:						
Hospitalization--						
Single Coverage	81.3	84.1	75.4	77.6	60.0	76.4
Family Coverage	78.2	70.5	68.5	63.5	48.4	68.0
Medical/Surgical--						
Single Coverage	80.8	85.4	75.7	78.2	60.0	76.7
Family Coverage	77.9	70.6	69.1	65.6	48.4	68.7
Major Medical--						
Single Coverage	79.3	84.8	76.1	77.4	60.5	76.2
Family Coverage	76.2	69.5	69.7	65.1	46.1	67.9
Dental--						
Single Coverage	85.4	78.0	75.7	82.3	56.0	78.9
Family Coverage	79.9	67.5	69.3	70.5	50.0	71.1
Vision Care--						
Single Coverage	76.7	90.0	62.2	76.4	-	73.9
Family Coverage	78.7	76.3	59.9	60.0	87.0	71.6
Prescription Drugs--						
Single Coverage	83.0	89.6	69.7	78.7	62.2	[illegible]
Family Coverage	78.5	68.3	70.7	60.4	56.3	69.1

See footnotes at end of table

Table 18.--Summary of Selected Fringe Benefits for Teachers in Reporting School Systems, by Per Pupil Expenditure Level of School System, 1983-84 (Continued)

	Per Pupil Expenditure					
	$3,500 or More	$3,000 to $3,499	$2,500 to $2,999	$2,000 to $2,499	Less Than $2,000	Total-All Reporting Systems
Percent Providing Income Protection Insurance	23.3	33.3	29.3	19.7	25.0	25.9
Mean Salary Coverage (%)	63%	65%	64%	66%	66%	65%
	17.1	27.3	24.8	15.4	20.0	20.8
Mean Monthly Benefit/Limit	$1,697	$1,959	$2,339	$1,610	$1,215	$1,897
	16.1	19.4	18.5	12.2	17.0	16.4
Percent Providing Group Life Insurance	65.3	75.2	72.3	66.7	59.0	68.7
Mean Policy Amount	$27,273	$21,644	$22,547	$16,178	$12,096	$20,497
Fully Paid1/	66.7	79.0	74.0	73.1	67.8	72.9
Mean Percent of Premium Paid If Less Than Full	64%	55%	58%	69%	61%	62%
	9.8	6.7	5.4	6.1	11.0	7.1
Percent Providing Professional Liability Insurance	69.4	57.6	69.7	67.7	73.0	67.6
Percent With Retirement Plans						
State Retirement System	95.9	97.0	96.8	96.8	97.0	96.7
Local Retirement System	5.2	3.0	1.6	2.2	-	2.5
Social Security Coverage	69.4	59.4	50.3	43.7	74.0	55.8
Tax-Sheltered Annuity	77.2	77.0	76.4	73.5	81.0	76.3
Early Retirement Option	51.3	49.1	47.8	41.2	20.0	44.2
Percent Providing Severance Pay	43.0	43.6	43.6	36.9	31.0	40.5
Percent with Tuition Reimbursement Provisions	39.9	42.4	29.9	25.4	16.0	31.2
Percent Reporting Collective Negotiations Agreement	87.6	86.7	77.7	63.1	38.0	73.3
Percent Paying All or Part of Teacher Org. Membership Dues	5.2	3.0	3.2	1.1	1.0	2.8

1/ Percents in detail lines based on number of school systems providing coverage.

Senator **Nickles**. To our panel, we thank your very much for your appearance. To all of our panelists, we appreciate it.

We will keep the record open for a couple of weeks to add any additional comments or questions from the committee. Thank you very much.

The committee is adjourned.

[At 12:20 p.m., the committee adjourned.]

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